ERM in Mergers & Acquisitions

Claims Loss Reserving Symposium

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David and Mike are Property & Casualty actuaries working in EY's Insurance Risk Management team: David in New York and Mike from EY's Chicago office. The Insurance Risk team assists clients with all aspects of Enterprise Risk Management across Property & Casualty, Life and Health. In a risk management or actuarial capacity we frequently join teams alongside EY financial and transactions specialists performing buy-side and sell-side due diligence exercises.

Introduction to ERM basics

Enterprise Risk Management

Introduction to ERM in Property Casualty Insurance

- Basic components
  - risk appetite, risk identification, risk mitigation, quantification and measurement, stress testing, capital modeling, risk-types, risk reporting
  - capital management
  - Regulators and Rating Agencies
- ORSA (NAIC version and internationally)
- Roles of CROs, risk committees and boards.
- Three lines of defense.
- Regulators and Rating Agencies

ERM in Mergers & Acquisitions

Viewpoint of the acquiring company
Drivers of acquisition strategy

- Expand the franchise faster than organic growth within the existing business.
- Seek economies of operation from greater scale.
- Import expertise (e.g. underwriting talent).
- Acquire brand and reputation of the target company.
- Access to new territories or markets or product lines.
- Achieve greater capital efficiency (capital needed for merged businesses with diversification credit *is less than* sum of previous separate parts). In certain cases, acquirer can view it that extra business gets a 'free ride'.

Shareholders of the acquirer will want to see that any deal increases shareholder value, irrespective of how a transaction is funded from:

- Cash from excess equity in the acquirer (but there is the alternative to return this directly to existing shareholders via dividends or buy-backs)
- Cash from raising new equity – from rights issue or new issuance of debt or preference shares
- Non-cash – offering acquirer shares in exchange for target shares

Viewpoint of the acquiring company
Risk involvement in acquisition strategy

The CRO and their Risk Team can input to the formulation of acquisition strategy:

- Does the company have the financial strength to embark on acquisition? How big is their 'war fund'? Need to consider pre- and post- transaction:
  - Statutory / regulatory capital requirement
  - Rating agencies' assessment
  - Internal view of capital strength (economic view?)
- Operational risks inherent in M&A:
  - Distraction of management attention away from running the existing business
  - Financial down-side not exposed during due-diligence
  - Undisclosed weaknesses of the target insurance company (possible reputational damage from contagion)
  - Can the right personnel be retained at the target company?
- New risks:
  - Are new territories or product lines sufficiently understood?
  - Unfamiliar regulatory regimes (especially if non-US)

Viewpoint of the acquiring company EY's 2016 CRO Survey findings

- Several CRO's, in companies where ERM is in a mature state of development, are already involved in wider aspects of business planning and strategy, inclusive of acquisition strategies. Other CROs express ambition to be more involved in future – such as:
  - Helping Executive and Board to understand where optimally to invest the next $ dollar
  - Exposing the risk involved in capital investment –

    $1 of expected profit from known existing business

    does not equal

    $1 of volatile profit from an unfamiliar venture
  - Analyzing the risk of 'doing nothing'

Assessing ERM at the target company Cause for alarm?

What conclusions should be drawn by the acquirer if:

- The target has not implemented ERM in a formal way?
- The target does not have a full-time CRO? (But a senior officer may be so-designated.)
- Three lines of defense do not operate for ‘Risk’?
- There is no ORSA – or the ORSA lacks detail (was it motivated only by compliance with NAIC model law?)
- The risk team is very small?
- There is no risk committee?

But:

- Risks may be very well understood and controlled, without the formal ‘trappings’ of ERM
- Target may argue that it is small / monoline / non-complex / ‘lean’ – or management subscribes to the school of thought that responsibility for Risk should not be displaced into a ‘second line’

Assessing ERM at the target company Information requested during Due Diligence

Data / Information Request (Qualitative)

- Org structure of Risk team
- Roles & Responsibilities (Risk Committee Terms of Reference, job specs)
- Policy and Procedures documentation. E.g. model risk management and validation polilcies
- ORSA (request several years historical)
- Recent regular Risk Reports (internal to Risk, to Executive, to Board Risk Committee)
- Correspondence between company and Regulator(s)

Data / Information Request (Quantitative)

- Risk Appetite Statement(s)
- Risk Limits (at corporate level and also operationally in underwriting, asset management, etc.)
- Risk mitigation, for example:
  - Details of hedging
  - Reinsurances in force
- Stress tests results
- Model outputs (e.g. economic capital model)
- Forward-looking business projections inclusive of stresses / economic capital

After processing the information received the Due Diligence process will likely involve interviews with CRO and key members of Risk team. May involve the modeling team at the target if capital models play significant role.

Assessing ERM at the target company
Challenges for ERM post-merger

Risk appetite

- Does the existing risk appetite suffice for the combined businesses, or will it require amendment?
- Timing issues – how to incorporate the acquired business into the business planning and risk management cycles

Risk measurement

- Bringing consistent metrics to both businesses. The two companies are unlikely to have the same stresses, VaR / TVaR choices, confidence levels.
- Eliminating modeling inefficiencies and differences:
  - Model design and governance
  - Standardization of model software platforms
  - Unifying to a single modeling team

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