

Risk Challenges Facing the Insurance Sector

January 2010



Developing a better understanding of risk exposures

Events of the last 12 to 18 months have highlighted the need for all players in the insurance sector to understand the true scale of their exposure across all categories of risk. Until recently, the so-called '1 in 200' year event was a concept on which insurers would happily model data with little regard for its validity, never really believing that such an event would occur in their lifetime. More often than not, the realisation of such a catastrophic event was considered theoretically rather than practically.

Is it really possible to articulate a scenario akin to a '1 in 200' year event? Consider the world of 200 years ago: Napoleon Bonaparte was at the height of his powers and Abraham Lincoln was approaching his first birthday. Given this incredible rate of change, to endeavour to describe such an event is almost certainly liable to be met with scepticism or even ridicule by key decision makers. With this mind it would seem churlish to believe that we could accurately predict the occurrence of even a '1 in 20' year event let alone a '1 in 200' event.

This situation leaves us with a dilemma. Although it may be extremely difficult to persuade key decision makers to pay more than a passing interest in what is often perceived as a largely theoretical risk, this is a necessity of paramount importance for the whole insurance sector in order to restore and rebuild public confidence in the industry. Recent events demonstrated the need to understand the full extent of the risks we are undertaking, and also confirm that a catastrophic loss event is much more than a theoretical scenario used for modelling purposes. In reality, a catastrophic event is a real live possibility which, if managed proactively, can be successfully mitigated or at least substantially reduced in impact.

What is the answer? Like so many questions the answer is simple; we must develop a proactive risk culture in which the value of understanding the full extent of our exposure to risk is used to drive key decision making. In turn, this will enable risk management to be used both as a catalyst for effective strategic planning and goal setting and as a key tool in the delivery of business objectives. Although the answer may be simple to articulate, the delivery can be extremely difficult to execute. Fortunately, four key factors can help drive the necessary cultural change.

Generating a commercial advantage

The primary principle underpinning the insurance model is the ability to fully understand the nature of a risk in order to make the acceptance of that risk commercially viable. This principle is not always apparent in many of the decisions insurers make. One of the few benefits of the recent financial crisis was the demonstration of the true value of a positive risk culture. Full awareness and appropriate consideration of prospective risks when making key decisions, which are key components of a positive risk culture, can provide the vehicle to generate a tangible commercial advantage, when compared to one's peers. The diminution or avoidance of loss resulting from the impact of an incident directly affects the bottom line. The more catastrophic the event, the greater potential to generate a commercial advantage from positively managing the risk. This is surely the major incentive to embedding a positive attitude to risk management into a firm's culture.

Using risk to identify opportunities

At the core of every firm's objectives is the ability to identify and maximise the potential opportunities that exist. Insurers, with their expertise in balancing risk and reward over many decades, should be best placed to identify and exploit any such potential opportunities.

How often do we see a firm embark on a potential opportunity only to find that the reality fails to deliver against the planned costs and benefits? A fully integrated risk management culture can play a significant role in preventing the development of 'the product that doesn't match the requirements of the marketplace' or 'the system that costs three times the original cost estimates'. Where an effective risk management culture is in place, the risks associated with such developments will be understood and measured. By comparing the benefits against the risks associated with each opportunity, the business can use results as key inputs into the decision making process. This will enable the business to:

- Prioritise opportunities to focus on those with the highest benefit to risk ratio
- Evaluate which opportunities are financially sound, taking account of the risk scenarios
- Adopt mitigation activities to reduce exposure to the risk to commercially acceptable levels
- Provide a mechanism for evaluating progress against benefits, making the decision to stop a non-productive initiative at the earliest possible stage
- Ensure that it maximises the return of its capital through the balancing of risk and reward

We must remember that good risk management is not about avoiding risk, as some people would contend. On the contrary, it is by taking risk that we generate profit. Good risk management balances risk and reward and thereby increases the probability of generating profit.

Stakeholder management

A positive risk culture is becoming an essential element of building an effective relationship with key stakeholders. Shareholders, rating agencies, regulators and customers all expect a firm to understand the risks they are taking and to ensure that excessive risk is mitigated or avoided. The reputational impact from poor risk management is already a key component in determining the success of a firm. There are many examples of poor risk management leading to customer attrition, increased cost of raising capital, regulatory sanctions and penalties, all of which have a direct impact on the firm's reputation. This in turn increases the pressure to deliver strategic goals, leading to the erosion of share value for shareholders.

Regulatory influence

Although this factor is listed last, for many the regulatory impact is already the key driver to embedding a positive risk culture across the organisation. Is this a good thing? It is true in the current climate that the regulator is demanding a much more transparent risk management process, requiring demonstrable evidence that risk is truly embedded across an organisation. This is not the forum to discuss whether the level of regulation is becoming excessive or not, but any organisation that uses this regulatory focus to gain momentum to develop and integrate a positive risk culture can only benefit from the experience.

The drive to deliver against Solvency II between now and 2012 will give firms a real opportunity to demonstrate how risk management is delivering tangible benefits for all stakeholders. The key to success is to embrace the cultural change needed rather than fight it. As there are bound to be those that simply 'tick the box' and miss out on the opportunity, there will be plenty of scope for those who use Solvency II to drive cultural change to gain a commercial advantage.

Summary

Who will emerge as winners and who will lose out? Time will tell but rest assured that those that understand and manage their risks as an integral element of their business model will be best placed to reap the rewards!

Phil Sellen
Chief Executive
Practical Risk Solutions

Phil Sellen of Practical Risk Solutions is a senior risk executive and chartered insurer with extensive strategic and business expertise in financial services. Visit www.practicalrisksolutions.net to learn more.

Methodware is a leading provider of governance, risk and compliance software solutions to the financial services marketplace, with more than 1,800 clients in 80 countries. Visit methodware.com to learn more.