Financial Services Practice

From Compliance to Value Creation: The Journey to Effective Enterprise Risk Management for Insurers
Introduction

During the past decade, boards and top management teams at insurance companies globally have given increased attention to enterprise risk management (ERM). The drive to implement more effective ERM is a response to greater regulatory scrutiny, more challenging rating agency standards and investor concerns about volatile macroeconomic conditions.

Many of these ERM programs are focused on playing defense – trying to keep up with new and more demanding compliance requirements – but are less concerned with capturing the full potential value of a robust risk framework. In addition, some ERM programs are developed in an “ivory tower,” without input from other functions in the organization, such as finance, product lines or sales. The result is that the programs are not well-grounded in organizational realities, do not achieve the desired behavioral changes, and ultimately fall short of goals for performance improvement.

The responsibility for risk-adjusted performance rests with the front line and business leadership, so their day-to-day compliance is essential to the success of an ERM framework. To be sure, an ERM framework cannot overcome the detrimental effects of poorly underwritten business, high costs or investments that excessively expose the capital base; however, it can play a critical role in reinforcing risk awareness and provide the practical tools and processes to embed risk-conscious behavior in everyday decisions.

Evidence suggests that organizations can create significant value by applying ERM practices, especially during market downturns. Using the S&P rating for the ERM function as a proxy for ERM sophistication, McKinsey observed that insurers with a higher rating during the 2008-10 financial crisis, for example, experienced less volatile equity returns and had a more resilient stock price (Exhibit 1, page 2).

This paper describes the elements of an effective ERM framework for insurers; discusses how ERM must engage with the business to achieve high impact, as well as the benefits that can be captured; and presents a vision for the next frontier of ERM, in which the risk function provides superior insights into business performance, enables active capital manage-
ment and challenges the business to improve the rigor of risk selection. We conclude with a description of the enablers of high-performing ERM that will help insurers reach the next frontier.

Exhibit 1

Insurers with stronger ERM capabilities have outperformed in terms of volatility and stock price

<table>
<thead>
<tr>
<th>S&amp;P rating of ERM function</th>
<th>Volatility of equity returns</th>
<th>2008 TRS versus S&amp;P 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weak</td>
<td>Percent</td>
<td>Percent</td>
</tr>
<tr>
<td>Adequate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strong</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excellent</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: S&P; McKinsey analysis

Investors place a premium on lower volatility stocks for any given level of return. Better risk management preserves equity value especially in periods of stress.
At its core, an ERM framework embeds the principles and practices of risk management into day-to-day business decision-making (Exhibit 2, page 4). The framework comprises the following five elements:

1. **Risk transparency and insight**: Providing insights into all relevant risks and developing early-warning key performance indicators (KPIs) for structural risks; preparing and disseminating risk reports; and stress-testing the resilience of the business in adverse scenarios.

2. **Risk strategy and appetite**: Defining the optimal risk-return tradeoff and aligning the top team on a clearly articulated risk appetite.

3. **Risk organization and governance**: Making ERM a board-level and top management priority; defining the mandate, role and aspirations for the ERM function; and establishing a robust governance framework for risk.

4. **Risk ownership and decision processes**: Building risk-return considerations into key business processes (for example, M&A, strategy and
From Compliance to Value Creation: The Journey to Effective Enterprise Risk Management for Insurers

5. Risk culture and incentives: Assessing and improving the risk culture across the organization, and potentially linking compensation to risk-adjusted measures (rather than P&L metrics, such as combined ratio or return on equity).

In this framework, the risk team is the owner of the ERM methodology, but is not the sole end user of ERM tools and procedures. Importantly, an ERM framework that remains confined within the risk function will not achieve its full value potential. This is a critical issue for insurers to address, as many still struggle to extend risk management beyond the risk function into the wider organization.

In many cases, perhaps surprisingly, insurers fail to apply ERM effectively because they regard risk pooling or risk transfer as the “bread and butter” of their business. Several successful insurance companies that have underinvested in a centralized ERM function argue that risk management is a core business skill. Others, however, see the ERM team as a second line of de-
fense that empowers and enriches the quality of business decision-making. In either case, central ERM teams often struggle to prove their value to the rest of the organization and generate a “pull effect” for their services and tools.

To create this “pull,” successful ERM teams provide insights that help optimize risk-return decisions. They help the business both manage downside surprises and optimize risk-taking (Exhibit 3). ERM can provide a deeper, more rigorous understanding of risks that moves one step beyond the risk-related knowledge and acumen currently possessed by the business.

Achieving these goals depends on a diverse set of factors: support from senior management; a clearly articulated risk strategy that is “owned” by the business; a rigorous ERM framework; relevant and reliable management information; and an effective model for engagement between ERM and the broader organization. Even with these ingredients, success is difficult to achieve. Like a good referee, risk management is most effective when it is not noticed, even though it is deeply involved in steering how the game is played.
How ERM Achieves High Impact

To achieve high impact, ERM must influence how business is conducted, ensuring that every important decision is made with a full understanding of the associated risks, trade-offs and shortcomings. In practice, ERM must engage with the business at three levels:

- **Strategy** – informing decisions related to the allocation of finite financial resources (such as capital) to opportunities at all levels (e.g., group, operating entity, product or channel).

- **Business execution** – identifying and supporting decision-making processes that have a material impact on the risk profile of the business, without becoming a roadblock to the smooth operation of the front line’s day-to-day activities and authority.

- **Operational** – ensuring that the focus of risk management remains on tail risks (low-frequency, high-impact events) rather than expected experience (high-frequency, low-impact events), and that the operational implications of business decisions are clearly linked to an understanding of the underlying risk drivers, such as asset-liability management and underwriting.
Business engagement is essential for effective ERM and has become even more critical as business complexity grows. This means that both risk teams and business leaders must adapt. Risk teams need to more clearly communicate how they can add value by helping business leaders make better-informed decisions, in contrast to their traditional role of controlling risk after it is already on the books. Business executives need to engage risk colleagues as partners, overcoming the natural fear of exposing weaknesses to colleagues outside of their business units (BUs). To make this partnership work, all executives need to be aligned on broader, long-term corporate goals, as opposed to shorter-term BU-level goals.

The value of high-impact ERM is significant and broad:

- Improved financial performance through the shifting of risk-taking from a compliance-driven process to a value-focused orientation
- More efficient allocation of resources (capital, personnel and systems) to the activities with the greatest risk-adjusted returns
• Broader understanding and appreciation of risk throughout the organization and at the board level
• Incorporation of risk into strategic decision-making (e.g., M&A, financing and new business development)
• Greater alignment of stakeholder expectations with the organization’s risk profile and appetite.

**Using risk appetite to inform business decisions**

A life insurer with regional growth ambitions designed and implemented a risk appetite framework through an extensive “co-creation” process between the risk team and business leaders. With the framework in place, the executive committee was keen to understand whether the insurer’s current business activities matched its risk appetite.

It became clear that the insurer’s exposure to investment risk exceeded the appetite set out in the framework. In response, the insurer fundamentally changed its approach to asset-liability management (ALM) and asset allocation, with implications for organization and governance structure. For example, the insurer established a dedicated ALM team and a new hedging team and strengthened its ALM committee.

Further, the insurer developed a tool that enabled it to conduct an objective assessment of potential M&A opportunities in emerging markets based on its risk appetite.
In the past decade, ERM has become a necessary competency for all insurers, not only the larger or more sophisticated companies. Regulators and ratings agencies demand the enterprise-wide approach to risk management. But increasingly, traditional stakeholders, investors and, to a certain degree, policyholders are also seeing value in ERM.

ERM will play a more significant role in the future in three ways: by providing superior insights into business performance; enabling active capital management; and challenging the business to improve the rigor of risk selection.

1. Providing superior insights into business performance

Many insurers still struggle with forward-looking, risk-based performance management, for several reasons:

- Business forecasts are based on deterministic (“single point”) estimates. For instance, a three-year operating plan will have revenue projections and capital-level estimates based on best- or worst-case scenarios, but typically will not consider a wider set of disruptive macroeconomic or business scenarios that can materially change the performance trajectory.
• Economic performance measures (for example, new business value added or risk-adjusted return on capital) are hard to apply to forward-looking expectations. Hypotheses with respect to model assumptions and market conditions are often not substantiated over time. In some cases, variances relating to economic conditions and year-on-year assumptions may turn out to be more volatile than expected.

• The trade-offs between short-term earnings and long-term value generation are insufficiently understood at the operational planning level. There is limited appreciation for the fact that shareholder preferences for long-term versus short-term performance vary over time, depending on market sentiment (and trading multiples) and perceived prospects for the industry.

ERM addresses each of these issues, and can help management and business leaders make choices that optimize business performance based on a deeper understanding of risk drivers. Importantly, the ERM team can help link financial planning to risk simulations – in particular, by developing multi-year, forward-looking stress- and scenario-planning. Closely linking these simulations to strategic planning and financial projections allows for pressure-testing of expected results under different macroeconomic and business assumptions. Establishing this link between risk simulations and financial planning helps identify which businesses are more vulnerable. Management can develop a risk mitigation plan for these businesses or shift investment priorities towards less vulnerable businesses.

At the portfolio level, the ERM team can provide stochastic analyses to ensure that portfolio valuation accounts for all options and guarantees underlying products and services, and that the capital measures fully reflect the risk-bearing factors.

Finally, in mature markets, there is an investor preference for cash generation in the short term over the promise of value creation in the future (particularly in life insurance). This creates tensions between company leaders and their investors over how, where and when to reinvest cash into the business, and when to distribute it to investors. Due to the long-
term nature of the business, cash and capital are often tied up for an extensive period (pay-back periods greater than five or even ten years are not uncommon). Investor focus on short-term profits is a major challenge to the nature of long-term businesses.

In this case, ERM can help navigate the complex trade-offs between short-term cash and long-term value. In life insurance, for example, ERM can:

- Provide transparency into where cash and capital are locked up on the balance sheet
- Provide transparency into how capital is being deployed across the in-force insurance business or investment risk-taking, versus supporting new business underwriting
- Suggest ways to accelerate the emergence of cash (and the cost of doing so), and show how the sources and uses of cash can best be balanced

Overall, the ERM team, through close cooperation with the actuarial and finance functions, helps ease the tension between short- and long-term considerations, taking into account the insurer's broader financial management framework.

2. Enabling active capital management

Active capital management entails making enterprise-wide decisions on capital needs and capital allocation across a group and its legal entities, taking into account constraints on capital fungibility and risk diversification. This approach enables an organization to dynamically reallocate capital to the most promising businesses, while reducing commitments to lower-performing businesses. Doing this well requires an integrated perspective on all risk mitigation and risk transfer opportunities (for example, reinsurance, securitization or investment risk hedges), as well as any diversification benefits.

The elements discussed in this paper – championing by senior management, stress testing, integration of risk metrics in the planning process and overall strong risk governance – are all prerequisites for active capital management (Exhibit 4, page 12). The assumptions and logic underlying capital decisions should be clear to the businesses. More importantly, beyond running the model itself, the ERM team has the role of challenging, refining and pressure-testing the underlying model assumptions, which are often provided by the business.
3. Challenging the business to improve the rigor of risk selection

Leading insurers set risk limits slightly below the level that would trigger a material concern, with the intention of initiating a dialogue with the business and challenging them to make the case for more capacity. They establish an escalation process that allows risks to exceed the limits, if businesses make the case. Escalating and challenging the limits is encouraged at the portfolio-wide level, as well as for exceptions relating to specific deals or opportunities that emerge.

The best-performing ERM teams (in insurance and other industries) do not set rigid risk limits, but rather help the business manage risk limits through proper governance mechanisms for escalation.
Enablers of High-Performing ERM

To reach the next frontier, insurers need to create a high-performing ERM function. The following best practices provide a foundation for success:

1. **Make risk a board and top-management priority.** There must be awareness among senior leaders of ERM’s goals, role and agenda. This is especially important in organizations where senior leaders have extensive sales, marketing or underwriting backgrounds but less experience and familiarity with quantitative principles.

2. **Focus on “hardware” and “software” equally.** Some insurers make the mistake of building the “hardware” – risk management models and IT systems – without paying enough attention to the “software” – people skills, risk governance and risk culture. Even organizations with a strong risk management framework and robust appetite can be hampered by ineffective soft skills or weak ERM governance.

3. **Create a rotation program to bring the best available talent to ERM.** ERM is often staffed with employees lacking front-line business experience. In some cases, business managers do not trust the judgment of their colleagues in the ERM function. Some high-performing ERM func-
tions address this issue by building rotation programs to bring in talent with superior business acumen, dynamic communication skills and the courage to “wave the red flag” with respect to excessive risk.

4. **Develop integrated risk and performance dashboards to drive management actions.** Insurers are organized by functions that typically focus on singular metrics. For example, the finance function focuses on accounting metrics, actuarial is focused on statutory and embedded-value metrics, and ERM focuses on measures of economic value. These silos make it impossible to optimize all metrics. Often, one metric is optimized at the expense of another – for example, protecting earnings reduces potential value growth. Top-performing insurers address this challenge by creating strong linkages between the finance, actuarial and ERM functions to build a holistic perspective on risk and performance, cutting across all functional views.
5. **Make the required investments.** Insurers with a leading ERM function appreciate the extent of the investment required to build a risk capability that works closely with the business to provide new levels of insight that extend beyond the management of downside risk. These activities are seen as core responsibilities of the ERM group, not project-based or extracurricular activities.

6. **Actively promote a risk-oriented culture.** Leadership demands a culture that challenges the status quo; business leadership and front-line staff are expected to “raise their hands” and speak out in the face of unacceptable risks. A risk-oriented culture should also tolerate intelligent mistakes, but have zero tolerance for lapses in integrity. Risk leadership entails actively asking: What values should we have, and how do we inculcate these values into our way of doing business?

* * *

During the last decade, ERM has evolved from a fledgling curiosity for top management teams to an essential ingredient in successfully managing a business. Most insurers are at the early stage of their journey to achieve best-in-class ERM. As they progress, ERM shifts from a control mindset to a business enabler, in which the risk function partners with the front line to support better decision-making (Exhibit 5). The potential value is significant, both for reductions in earnings volatility and improved financial strength. A top-performing ERM function will play a large role in determining winners and losers in the insurance industry.
Contact
For more information about this report, please contact:

Giambattista Taglioni
Director
giambattista_taglioni@mckinsey.com

Ari Chester
Principal
ari_chester@mckinsey.com

Alexander Gräwert
Principal
alexander_grawert@mckinsey.com