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Insurance Risk Management: Global Trends and Developments

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By understanding recent management trends and evolving regulatory requirements, international insurers can begin to adapt their enterprise risk management (ERM) practices to address both current challenges and future events.
Global ERM Trends in the Insurance Industry

Recent years have seen significant changes in the way insurance businesses approach enterprise risk management (ERM), driven in large part by global business trends and evolving regulatory requirements. Indeed, the very definition of ERM – and the outcomes companies expect to achieve through it – is shifting gradually in response to changing business practices, evolving risks, and an increasingly global business environment.

Consider, for example, the definition spelled out by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). COSO’s landmark 2004 publication, “Enterprise Risk Management – Integrated Framework,” defines ERM as “a process, effected by an entity’s board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.”

Compare that 2004 definition, including COSO’s focus on process, assurance, and objectives, with the draft definition in its proposed new framework, “Enterprise Risk Management – Aligning Risk With Strategy and Performance,” which is expected to be finalized in 2017. The executive summary that accompanied the exposure draft of the new framework defined ERM as “the culture, capabilities, and practices, integrated with strategy and execution, that organizations rely on to manage risk in creating, preserving, and realizing value.”

The differences are more than just a matter of semantics. The new COSO ERM framework also presents an organized ERM structure composed of five major components and 23 supporting principles (Exhibit 1). It is important to note that the new COSO framework is still in draft and the names of components and associated principles are still subject to change. However, this framework provides general guidance for creating a risk framework specific to each organization.
Beyond the specifics of the impending new COSO framework and the adoption of several sweeping new regulatory schemes, a number of other general ERM trends also are affecting the insurance industry. These include an increased focus on fair customer outcomes, a growing view that proactive risk management can add value to an organization, and a focus on newly emerging risks, including cybersecurity risk, geopolitical risk, and innovation.
Business Responses to Trends

In the context of these broad trends, each individual insurance business should also address specific risk management challenges unique to its own situation. In many cases, these challenges are not necessarily technical in nature, but rather relate to people issues and corporate culture.

Among the recurring ERM-related challenges insurance businesses encounter is the need to clarify roles and responsibilities related to ERM duties and activities, while at the same time increasing collaboration among various functional areas of the business. At a deeper level, this means establishing a corporate culture in which everyone – starting at the board level and continuing on through the organization – views risk management as a core element of their day-to-day responsibilities.

In addition to these broad cultural responses, businesses also should address a variety of pragmatic, operational issues, such as dedicating sufficient resources to ERM functions, connecting and coordinating various elements of the ERM framework, providing timely and relevant information to management, maintaining ongoing communication with regulators, and documenting evidence of regulatory compliance.

A final point, in terms of general trends, is the continuing need for insurance organizations to recognize that the benefits of effective ERM are broader than just reducing potential losses and managing adverse events. More and more, insurance businesses recognize that ERM also has potential proactive benefits. Among these benefits are improvements in capital efficiency, risk ratings, and credit ratings that allow businesses to raise capital more effectively. Further, ERM is an opportunity to engage with customers, regulators, and other stakeholders about how risk management activities are central to business management and decisions.
Specific Regulatory Developments

The various cultural and technical issues related to ERM should be viewed in the context of recent or current national and international regulatory developments, which reflect the broad trends just discussed. These developments are examples of how global ERM trends can affect individual insurance organizations at both the strategic and operational levels. Three such regulatory developments merit specific attention.

1) International Association of Insurance Supervisors (IAIS) Framework

This globally recognized framework applies to more than 140 countries, with compliance assessed by the International Monetary Fund and the World Bank. Even though individual companies do not report directly to the IAIS, the organization’s framework has directly affected regulations in most countries.

Insurance supervisors in the 140 countries covered are expected to enforce compliance with 21 core principles within five broad categories: solvency; group supervision, coordination, and crisis management; conduct of business; corporate governance and disclosure; and supervisory powers and measures.

Companies categorized as internationally active insurance groups (IAIGs) must comply with additional requirements. IAIGs are companies that write premiums in at least three different jurisdictions or that generate at least 10 percent of their premiums outside their home countries. This broad category applies to a large number of companies, all of which are required to meet additional ERM standards.

Global systemically important insurance groups (GSIs) represent a final group of insurance companies defined by IAIS. This is a group of eight or nine of the largest international companies, all of which are subject to even more stringent standards.

Among the standards applied to IAIGs and GSIs are enhanced international capital standards (ICS), detailed, risk-based capital requirements controlling the level of capital a firm must hold as a percentage of its risk-based assets. Version 1 of these standards is expected to launch in 2017, with the final version scheduled to be adopted by 2019. Although the final ICS language has not yet been published, many large insurance organizations are taking steps now to prepare for compliance.
2) Solvency II
This regulation, which affects insurance organizations in all European Union (EU) nations, is designed to provide a more consistent way of measuring and managing risk across businesses in order to enhance customer protection. This emphasis reflects the ongoing trend of focusing on fair customer outcomes, while at the same time attempting to quantify the value that is added to the business through various risk-related decision-making processes. Solvency II has elevated risk management practices across all risk types, including current areas of focus, such as cybersecurity. Further, the principles of Solvency II are becoming more widely adopted across various geographies and jurisdictions.

The effects of Solvency II also should be viewed in the context of today’s evolving risk environment, particularly the increased emphasis on cybersecurity occurring in virtually every industry, including insurance. Enhanced ERM frameworks can help by facilitating the identification, measurement, monitoring, management, and reporting of cybersecurity risks against a clearly articulated risk appetite. Solvency II also is driving an increased emphasis on the timely management of information so companies can better anticipate the effects of possible future events.

Solvency II has led to a significantly increased focus on risk and capital management. It should be noted, though, that any additional focus on financial risk management should not come at the expense of good business risk management and, in particular, operational risk management.

Another specific Solvency II requirement is for insurance companies to conduct an annual Own Risk and Solvency Assessment (ORSA). This requirement actually has a far-reaching global effect, as countries throughout the Americas, the Asia-Pacific region, and parts of Africa also are adapting to ORSA requirements broadly equivalent to the Solvency II requirements in Europe.

3) National Association of Insurance Commissioners (NAIC) Guidance
In the United States, one of the chief objectives of the NAIC has been to improve regulatory consistency across the various states. In October 2017, NAIC issued a brief discussing the importance and advantages of ERM, and pointing out that NAIC was instrumental in leading all U.S. states to adopt a uniform model law that addresses various risk management issues.
The NAIC model law requires insurers above a specified premium threshold to maintain a risk-management framework based on a set of core principles that reflect IAIS guidance. Among other actions, the affected companies also are required to complete an ORSA and file a confidential annual ORSA summary report with their lead state supervisors. Most states are expected to adopt this standard by the end of 2017.

A final point on regulatory trends merits special mention. In recent years, regulators have tended to shift their focus onto reducing the risk of poor customer outcomes. More broadly, this shift leads to increased attention on issues such as governance, conflicts of interest, product design, and the culture of an organization, with an eye toward how factors such as these might contribute to poor outcomes.

Trends in Operational Risk

Some argue that Solvency II's emphasis on risk and capital management also has produced some unintended consequences. Solvency II has placed significant emphasis on modeling and financial risk, an emphasis that led to a reduced focus on operational risk management. Recognizing this potential weakness, forward-thinking businesses are beginning once again to look more closely at operational risk.

Over the years, insurers have been challenged by operational risk systems and processes, which can be resource-intensive and inefficient while providing little return on business investment. Often, operational risk processes are regarded as separate activities, not as closely aligned with business activities and decisions. Some companies are starting to focus more closely on determining whether their processes are effective and efficient and whether they add value to business decisions.
With its requirement that companies set aside capital for operational risk, Solvency II has also led to developments in how firms model operational risk. Solvency II enables two methods firms might use for this purpose:

- **A standard formula.** Expected outcomes are calculated based on technical provisions or a percentage of premiums. Although simple to calculate and easy to use, this approach does not accurately reflect the business’s risk profile and can’t be diversified across the various types of capital.

- **An internal model.** Tailored to the individual firm’s situation, internal models are generally more risk-sensitive and often better reflect the benefits of diversification. These benefits are not without cost, since the use of such a model is subject to regulatory approval – which can be a demanding process that also involves significant ongoing overhead.

Recently developed hybrid modeling approaches can help insurance businesses address some of the shortcomings of more standardized approaches and traditional data models by combining the best aspects of loss data and scenario-based methodologies.

### Exhibit 2: Operational Risk Modeling Approaches

<table>
<thead>
<tr>
<th>Formula-Based Estimate (e.g., Standard Formula)</th>
<th>Loss Data-Based Model</th>
<th>Hybrid Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Simple, reliable reflection of size of a business</td>
<td>✓ Links to hard data give the approach reliability</td>
<td>✓ Forward-looking risk management linkage</td>
</tr>
<tr>
<td>× Does not reflect risk profile of organization</td>
<td>× Lack of confidence in internal loss data, need for external data</td>
<td>✓ Scenarios supplemented by hard data</td>
</tr>
<tr>
<td></td>
<td>× Difficult to link to forward-looking risk management</td>
<td>✓ Becoming the method of choice amongst large insurers</td>
</tr>
<tr>
<td></td>
<td>× Approach less common in insurance than banking</td>
<td>× Continued significant reliance on expert judgement</td>
</tr>
<tr>
<td></td>
<td></td>
<td>× Linear process, difficult to spot reinforcing feedback loops that could increase risk</td>
</tr>
</tbody>
</table>

Source: Crowe analysis
Hybrid operational risk models are becoming more widely used. Specifically, large insurers subject to Solvency II requirements are using them to better understand the operational risks they face and the necessary trade-offs between the costs of risk and the costs of control. As a result, these models can provide valuable input into critical business decisions and help firms manage a range of risks – from typical, high-frequency, low-severity risks to more severe risks.

Future ERM Priorities

The global trends and regulatory developments discussed here are long-term in nature and potentially far-reaching in their impact. In this environment, it’s wise to assume that the most successful insurance organizations will be those that focus not only on compliance with specific risk and capital management requirements, but also on embedding good business risk management principles and practices into their strategic and operational decision-making.

At the same time, they should continue to adapt to changing business practices, evolving risks, and an increasingly global business environment. Recognizing these ongoing developments and understanding their potential impact can help insurers more effectively establish sound ERM priorities in the years to come.
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