

Risky Business

Mr Giles R Ward, Regional Managing Director – MENA, ACE Insurance, identifies the kinds of risks facing insurance companies and recommends risk management practices that companies can adopt.



Insurers are usually keen to develop good risk management practices within their client base, but they face a wide spectrum of risks in their businesses. It is not hard to find examples of failure in the sector – where sudden and unexpected events have overtaken sometimes long-established firms. Recently, we have seen a number of major industry players destroy billions of dollars of shareholder value through forays into more abstruse investment sectors, risking their long-term viability. In the Middle East, examples can also be found where companies have failed or have encountered significant problems, and where better risk management would undoubtedly avoided or mitigated the situation.

Core Principles

The core principles of good risk management apply to insurers in very much the same way as they do to other industries. However, insurance companies arguably face an unusually wide variety of risk factors that could impact their business, and a continuous and comprehensive process to manage risk is, therefore, particularly important to maintaining corporate viability and delivering sustainable returns to shareholders in the industry.

It is important to recognise at the outset that risk has both an upside and a downside. Insurers are, of course, in the business of identifying and pricing risk by way of the products that they sell. So risks can present opportunities. However, the same rigour that is applied to their core businesses is not always applied by insurance companies to the other aspects of their operation as well as it should be.

A simple definition of risk is: the combination of the probability of an event and its consequences. This definition helps guide a straightforward, step-by-step, approach to risk management:

- **Identify** – what risks does the organisation face?
- **Evaluate** – what is the likelihood of each risk, and its potential consequences?
- **Prioritise** – which risks does management need to focus on in the short, medium and long term?
- **Mitigate/ Exploit** – what action can be taken to reduce risk (such as increase controls, purchase insurance, outsource activities, pursue less risky alternative strategies etc.)? Conversely, perhaps the risk presents an opportunity, to launch a new insurance product for example; so what steps need to be taken to maximise this?
- **Review** – assess the impact of mitigation activity and re-run the risk management process on a regular basis so as to ensure new or changed risks are recognised and acted on.

Complex Organisations

Insurers are complex organisations and risk identification should involve input from all aspects of the business in order to address this complexity. Leaving the process of risk management to a narrowly drawn committee as a “tick box” response to a regulatory requirement – as is often the case – risks the possibility of over-looking areas that could have a significant impact.

Some areas to consider are:

- **Underwriting** – insurance products are mispriced, or inappropriate risks are accepted;
- **Distribution** – distributor concentration leaves the business vulnerable to competitor action;
- **Claims** – invalid claims are paid or valid claims are rejected (leading to reputational risk), claims payment “leakage” occurs due to poor employee training;
- **Accounting** – inaccurate recording of data leads to poor management decisions, poor credit control procedures lead to unnecessary bad debt write offs;
- **Investment** – inappropriate selection of investments, or over-concentration in particular asset classes, leading to write downs and / or cash flow issues;
- **Systems** – vulnerability to malicious attack, loss of client data;
- **Human Resources** – poor employee morale leading to reduced productivity, high employee turnover impacts cost base and customer relations.

Internal & External Risks

As can be seen from the list above, the risks insurers face can fall into two broad categories: those due to internal factors and those due to external factors.

External factors can be thought of as either being specific or systemic.

Specific external factors might be the actions of direct competitors, such as launching a new product in the same competitive space, the loss of a major customer or distribution channel, a major fire at a client’s premises leading to a large claim, or the fall in value of a particular investment in the asset portfolio.

Systemic risk, on the other hand, might include cultural shifts leading to changing patterns of claims frequency in a particular class of business; a substantial change in the regulatory environment; or economic conditions leading to the deterioration in performance of an entire asset class.

Generally speaking, insurers tend to have a better understanding of specific external factors than they do on systemic ones – the LMX spiral of the 1980s is a good example of this. Each individual risk transfer agreement probably made sense to the parties involved – but the

cumulative position was unsustainable with original risks being exchanged in ever-decreasing circles such that, once tripped, the system quickly collapsed and caught both companies and investors unaware. Thus, it is important to consider risk not just at the operational level, but also to consider broad strategic risk facing the enterprise and the industry as a whole: something which should certainly be on the Board's agenda.

Internal risks in non-core areas can be underestimated too. Insurance company managements might be expected to understand the underwriting and claims process well, but failed IT projects or poor HR management can have an equally devastating effect on company performance in the long run.

Structured Approach

Good risk management begins with a comprehensive review of all the potential risk factors as described above, and how they each might impact the insurer based on the current operation and the future strategic plans of the firm. Once a register of these risks is created for each major operational area (eg, underwriting, claims, reinsurance, investments, etc), a useful way to progress is build a probability / impact matrix for each area of activity, as shown in Figure 1.

In the example shown in Figure 1, management might consider the following actions to reduce the impact of the identified risks:

- Implement electronic imaging solution to assess damage repairs at head office;
- Purchase XOL reinsurance to protect against multi-vehicle accidents;
- Improved segmentation analysis to define which areas are producing the highest rate of increase in frequency, allowing pricing to be adjusted accordingly;
- Invest in more comprehensive automated quotation systems;
- Increase staff training.

It is easy to see how the same relatively simple meth-

odology can be applied to different areas of an insurer's operation.

Risk Appetite

An aspect of risk management that is frequently given insufficient attention is the question of formalising an organisation's risk appetite. After all, once identified and measured, how does management know what to do with risk unless it is clear what level of risk is acceptable? Equally obviously, in the real world, a zero risk organisation is likely also a zero return one! Hence, the Board needs to provide direction in terms of what frequency and magnitude of risk is acceptable in order to pursue the firm's objectives.

In many areas, this could take the form of clear financial guidelines, linked to the cost and availability of capital to the firm. For example, an insurer might decide to purchase reinsurance to the point where the net retention it will bear on any one catastrophic event is no more than 5% of its capital base; it might limit the per cession and aggregate amounts ceded to any one reinsurer (perhaps linked to their individual claims paying ability rating); or it might fix an investment strategy that had no more than 20% of its portfolio in equities so as to avoid capital impairment in volatile markets. Risk appetites are enterprise-specific and relate very much to the individual firm's goals and resources – a \$5 million net loss might decimate a small company, but not trouble the Board of a global insurer. But they do need to be explicit in order to form the basis for the decision on how to treat identified risks.

Future Trends

Risk management has gained the attention of insurance regulators and rating agencies in recent years. Business viability and claims paying ability are obviously inextricably linked to a business' approach to risk. The introduction of risk-based capital models for solvency requirements is an obvious example of how the management of risk can have a direct impact on insurers, allowing for greater capital efficiency where companies implement successful risk management strategies.

Moreover, we now have numerous examples of how increased globalisation has changed the risk environment, sometimes helping firms to mitigate risk (through diversification, for example), but also creating a much more complex set of interdependencies that can give risk to higher levels of external systemic risk.


In conclusion, just as the risks the industry faces are changing, risk management is an evolving discipline, and one in which the insurance industry needs to invest in if it is to remain an effective and resilient component of the financial system. 

Figure 1: Probability / Impact Matrix Example – Motor Underwriting

| | | Impact of Event | | |
|----------------------|--------|--|---|--|
| | | High | Medium | Low |
| Probability of Event | High | | | Staff mis-quote price on individual risk |
| | Medium | Collusion between claims assessors and repairers leading to increased claims costs | Gradual rise in small claims frequency due to increased traffic density | |
| | Low | Multiple insured vehicles involved in same accident | Staff accept 'decline risk' | |