April 3, 2012

Useful Outputs Should Be the Ultimate Goal.

As Risk Management Evolves, Focus Must Be Results-Oriented

As risk management continues to evolve in the insurance industry and the ability to understand risk further improves, the focus on a company's risk management continues to grow, watched by many different constituents. Rating agencies and regulators are two of the parties most focused on risk management, but as this discipline continues to develop and information becomes more readily available, risk management will garner even greater focus.

One concept that has been slow to catch on broadly across the industry is risk-adjusted return. Several issues have inhibited the acceptance of the concept. First, for risk-adjusted return to be viewed as important, a broader spectrum of constituents must understand and focus on the concept and work toward approaches to measure it. While some in the equity markets have looked at risk-adjusted return, reporting by companies is neither broad nor consistent, as the concept is still developing.

Beyond listed companies, mutual and cooperative constituents need to more broadly embrace the importance of risk in determining acceptable levels of profitability relative to the risk that the company absorbs. While there is no requirement to return profits to a shareholder, there is an obligation to ensure the organization's capital is not placed at risk while not achieving even risk-free returns.

Another reason risk-adjusted returns have not received more attention is that the initial focus has been on the process of risk management rather than on the risks identified, their impact and how they are being managed. While the risk management process is important to understand, and clearly an organization's risk culture matters greatly, the process needs to be understood, not prescribed. The ultimate benefit of risk management comes from identifying, measuring and managing risk.

The problem with requiring any company to follow a prescribed risk management approach, or someone else's approach, is that the company does not own that approach. A prescribed method or a review focused on a company's risk management process, rather than on the output, results in little true value to the company, which will target meeting the process expectations and not the real goal of risk management.

Regulators around the world are launching initiatives that will require insurers to identify, evaluate and address risks that affect their current and future solvency. In Europe with the Solvency II framework, which in turn affects those jurisdictions seeking equivalency with the European regime – and possibly continuing at the global level – expectations for risk management have been set there. Depending on the outcome of current discussions at the International Association of Insurance Supervisors, there is always the risk that regulation may become increasingly prescriptive. In the United States, the National Association of Insurance Commissioners (NAIC) is undergoing the implementation of its version of the Own Risk and Solvency Assessment (ORSA), which takes a different approach.

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A.M. Best believes the NAIC's ORSA guidance provides areas to be discussed and essentially an outline for documenting the company's ORSA, but not a prescriptive requirement for what must be done. It allows for a flexible framework in completing the documentation to fit a company's risk management process into the ORSA. Further, the Guidance Manual acknowledges there is no standard set of stress conditions that each company should run. The focus of the ORSA program clearly is to learn about a company and the risks it faces in its operations.

A.M. Best is encouraged by the NAIC's ORSA guidance, but the key point in this process will come with the actual implementation of the program. The training provided in the implementation process will be critical to ensuring a consistent application across the states in line with the expectations of the Group Solvency Issues Working Group. This seems to be clearly understood, based on the judicious process taken in the rollout so far and the future training plans.

Smaller companies also must understand that although there are size thresholds within the ORSA Guidance Manual, this should not be viewed as a "free pass," merely greater freedom in developing their own risk management processes. All companies should embrace risk management as a central function, integrated into their ongoing management and corporate governance. In doing so, it is important that the risk management process fits the company's risk profile.

A.M. Best stresses that all companies need to ensure that their risk management is conducted to identify, quantify and manage risks and not to meet outside parties' requirements. Evaluations of enterprise risk management, whether by rating agencies or regulators, can err toward being too prescriptive. In its own rating process, A.M. Best expects all companies to have some form of risk management in line with their risk profile. A.M. Best endeavors to understand a company's risk management as is appropriate to the individual insurer. Information is gathered through management meetings and ongoing discussions, and can generally benchmark a company's performance by using these methods alongside the Enterprise Risk Management responses that are received in A.M. Best's Supplemental Rating Questionnaire.

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