Seminar III: Risk Culture and Enterprise Risk Management

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RISK CULTURE
IN THE INSURANCE SECTOR

David Ingram, CERA, FRM, PRM
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Risk Culture

- What are Insurers saying about Risk Culture?
  - GSIIs
  - Case Study – SCOR
- Ten Risk Culture Practices
  - Examples from GSIIs
- Risk Culture as Company Culture
  - Case Study – Partner Re

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Insurance Companies

- The Financial Stability Board has designated nine insurers as Global Systemically Important Insurers
  - AIG
  - Allianz
  - Aviva
  - AXA
  - Generali
  - MetLife
  - Ping An
  - Prudential (UK)
  - Prudential (US)

Seven of the nine mention Risk Culture in their 2013 Annual Report

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Risk Culture in 2013 Annual Reports

AIG - Our risk governance structure fosters the development and maintenance of a **risk and control culture** that encompasses **all significant risk categories**. **Accountability** for the implementation and oversight of **risk policies** is aligned with individual corporate executives, with **the risk committees** receiving **regular reports** regarding compliance with each policy to support **risk governance** at our corporate level as well as **in each business unit.**

Aviva - We manage risk through our choice of business strategy, underpinned by our **business culture and values**, continuously seeking to identify opportunities to maximise risk-adjusted returns. Rigorous and consistent risk management is embedded across the Group through our risk management framework.

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Risk Culture in 2013 Annual Reports

AXA - As an integrated part of all business processes, Risk Management is responsible for the definition and the deployment of the Enterprise Risk Management (ERM) framework within AXA Group, cemented by a **strong risk culture**:

Generali - effectiveness of the risk management system through the spread of **a risk management culture based on shared values**.

Ping An - The Group Executive Committee **promotes a culture of comprehensive risk management** within the Group **through** the inclusion of risk indicators in performance evaluation which **integrates risk management culture into its corporate culture.** The Group **aims to promote a risk culture** and to enhance risk awareness.

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Prudential (UK)
2013 Annual Report

- Our Group Risk Framework describes our approach to risk management, including provisions for risk governance arrangements; our appetite and limits for risk exposures; policies for the management of various risk types; **risk culture standards**; and risk reporting.
- Group Risk has responsibility for establishing and embedding a capital management and risk oversight framework and **culture consistent with our risk appetite** that protects and enhances the Group's embedded and franchise value.

Risk culture
(Unaudited)
We work to promote a responsible risk culture in three main ways:

a By the leadership and behaviours demonstrated by management;
b By building skills and capabilities to support management; and
c By including risk management (through the balance of risk with profitability and growth) in the performance evaluation of individuals.

The remuneration strategy at Prudential is designed to be consistent with its risk appetite, and the Group Chief Risk Officer advises the Group Remuneration Committee on adherence to our risk framework and appetite.

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RISK CULTURE
CASE STUDY - SCOR

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Case Study SCOR

- What does Risk Culture mean for a (re)insurer? In fact, Risk Culture forms ***the basis of a solid risk management policy within the company***, as illustrated in the Greek temple.

Source: SCOR 103 page booklet on ERM (2010)

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Case Study SCOR

The foundation of Risk Culture is strong internal risk-based governance. At SCOR this governance is overseen by a ***Board Risk Committee*** which reports to the Board of Directors. The main responsibilities of this committee are:

- Ensuring that the company has an ***effective ERM framework*** in place;
- Proposing an appropriate ***risk appetite framework*** to the Board and ensuring this is clearly communicated to and understood by all stakeholders, in particular by staff;
- Monitoring and reporting on the Group's ***risk profile*** to the Board;
- Monitoring and reporting ***critical risk issues*** to the Board.

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Case Study SCOR

- Risk Culture benefits from the appointment of a *Chief Risk Officer* (CRO) who is a member of the company's Executive Management. He/she is responsible for:
  - the management of the above areas and is expected to
  - provide regular updates to the company's Executive Management (weekly at SCOR) and
  - the Board Risk Committee (quarterly at SCOR).

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Case Study SCOR

- At SCOR, the day-to-day management of these areas is dealt with by the ***Group Risk Management (GRM) department*** which reports to the Group CRO.
- ***The operating divisions*** (SCOR Global P&C and SCOR Global Life) also ***have their own Risk Management organizations***, headed by a Division CRO who has a dotted line reporting to the Group CRO. Both organizations work closely with GRM.

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Case Study
SCOR

- From a governance point of view it is also imperative that a ***clear separation of roles*** between risk decision takers and risk managers exists.
- In particular the risk takers must be **accountable** for their business decisions.
- The various levels of **decision making should also be risk-based**, e.g. critical risks should be owned and managed by members of Executive Management.
- At SCOR, various risk-related committees, at or below the Group Executive Management level, provide formalized decision making forums which enable the views of risk decision takers and risk managers to be taken into account.

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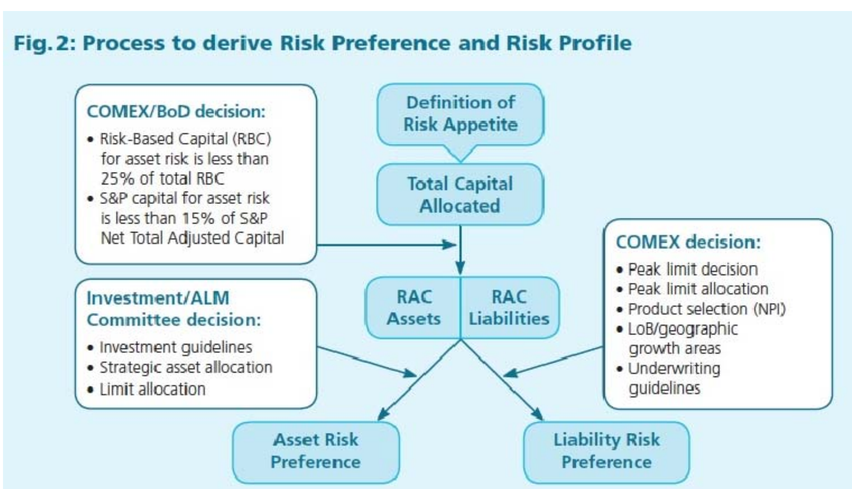
Case Study
SCOR



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Case Study
SCOR

Risk Culture is reinforced by:

- A **remuneration system** which incorporates incentives/ disincentives for management and staff to optimize risk and returns.
  - The formula for SCOR's staff bonuses incorporates a significant element in respect of individual performance which is based on objective evaluation criteria including a part which rewards individual contributions to effective risk management;
- Risk-based, Group-wide **policies and guidelines** in areas such as ERM, reserving, underwriting, accounting, asset management, human capital management, compliance, internal audit, etc.;
- Risk-based internal control standards (including exposure limits) at the process level.

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TEN PRACTICES
STRONG RISK CULTURE

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Ten Risk Culture Practices

1. Risk Governance
2. Risk Appetite
3. Compensation
4. Tone at the Top
5. Accountability
6. Challenge
7. Risk Organization
8. Broad participation in RM
9. RM Linked to strategy
10. Separate Measurement & Management of risk

Source: Financial Stability Board, National Association of Insurance Commissioners, ERM Rating Criteria from S&P and AM Best.

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Risk Governance - GSIIs

Allianz – Supervisory Board has Risk Committee. Management Board approves Group Risk Policy. Has Capital, Risk and Finance Committees

Generali – Board approves Risk Management Policies, Strategies and Tolerance. Receives periodic risk profile reports

Aviva – Board has Risk Committee which recommends Risk Appetite for Board approval. Risk Committee makes periodic reports to the board about significant risk exposures.

Prudential (US) – Board oversees Risk Profile and management's process for assessing and managing risk. Specific committees oversee specific risks.

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Risk Appetite - GSIIs

Allianz - defined by a clear risk strategy and limit structure. Close risk monitoring and reporting allow **detection of potential deviations from our risk tolerance at an early stage**

AIG - Risk Appetite Framework integrates **stakeholder interests**, strategic business goals and available financial resources. Our risk tolerances take into consideration regulatory requirements, rating agency expectations, and business needs.

Generali - Defined within the Group Management Committee **along with proposals for updating the internal controls and risk management system**.

Aviva – define risks selected in pursuit of return, risks to minimise and risks to avoid or transfer, and the amount of capital that can be put at risk

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Compensation - GSIIs

Ping An - To meet regulatory requirements and to support the Company strategy and business development in a healthy and effective manner, have implemented a top-down **performance management system that takes into account risk and compliance management**.

Prudential (UK) – designed to be consistent with its risk appetite, and the Group **Chief Risk Officer advises the Group Remuneration Committee** on adherence to our risk framework and appetite. Include risk management (through the balance of risk with profitability and growth) in the performance evaluation of individuals.

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Tone at the Top - GSIIs

Allianz - The Allianz Group's management feels **comfortable with the Group's overall risk profile** and has **confidence in the effectiveness of its risk management framework** to meet the challenges of a rapidly changing environment as well as day-to-day business needs. As a provider of financial services, we consider **risk management to be one of our core competencies**.

Prudential (UK) - has established the Group Risk Committee to assist in providing leadership, direction and oversight in respect of the Group's significant risks, and with the Group Chief Executive and the Chief Executives of each of the Group's business units.

Accountability - GSIIs

AIG - **Accountability** for the implementation and oversight of risk policies is aligned with individual corporate executives, with the risk committees receiving regular reports regarding compliance with each policy to support risk governance at our corporate level as well as in each business unit. Limit breaches are required to be reported in a timely manner and are documented and escalated in accordance with their level of severity or materiality. Responsibility for addressing and/or remediating any breach rests with individual or individuals within the specific unit that experienced the breach, who must report regularly on their progress to the ERM market risk team.

Challenge - GSIIs

AXA - **Systematic second opinion on key processes**: Chief Risk Officers ensure a systematic and independent second opinion, on AXA material decision processes, like L&S and P&C new product characteristics (risk-adjusted pricing and profitability), P&C and Life Economic reserves, Asset and Liability Management studies, Asset allocation and new investments, and Reinsurance.

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Risk Organization - GSIIs

AXA - **Chief Risk Officers** are responsible for ensuring that the top management reviews and approves the risks they carry in their company, understand the consequences of an adverse development of these risks, and have action plans that can be implemented in case of unfavorable developments

Generali - Risk management relies on **an effective organizational structure based on clear definition of risk roles and responsibilities**.

Ping An - the Group Risk Monitoring Committee's (RMC) main responsibilities include **overseeing the establishment of risk management organization in subsidiaries** and monitoring their performance

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Broad Participation - GSIIs

AIG - ERM supports our businesses and management in the **embedding of enterprise risk management in our key day-to-day business processes** and in identifying, assessing, quantifying, managing and mitigating the risks taken by us and our businesses.

AXA - **Risk Management is a local responsibility**, in accordance with GRM standards and guidelines.

Ping An - The Group Risk Monitoring Committee's (RMC) main responsibilities include: overseeing the establishment of risk management organization in subsidiaries and monitoring their performance; supervising the implementation of the risk management system in each subsidiary or business line, and **promoting a culture of comprehensive risk management within the Group.**

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Link to Strategy - GSIIs

Ping An - **enterprise risk management system is aligned with the strategies of the Group**, as well as with the characteristics of our business. Risk management supports decision-making and facilitates the effective, sustainable and healthy growth of the Group, which helps the Group to become China's leading personal integrated financial services provider and ultimately fulfill our grand vision of becoming a globally leading integrate financial services group.

Prudential (UK) - Group Risk has responsibility for establishing and embedding a capital management and risk oversight framework and culture consistent with our risk appetite that protects and enhances the Group's embedded and franchise value.

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Separation - GSIIs

AXA - Chief Risk Officers are **independent** from operations ("first line of defense") and internal Audit Departments ("third line of defense"). Risk Management Department, together with Legal, Compliance, Internal Financial Control, Human Resources and Security Departments constitute the "second line of defense" which objective is to develop, coordinate and monitor a consistent risk framework across the Group. Risk Management Department, together with Legal, Compliance, Internal Financial Control, Human Resources and Security Departments constitute the "second line of defense" which objective is to develop, coordinate and monitor a consistent risk framework across the Group.

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RISK CULTURE AS COMPANY CULTURE

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Risk Culture at Partner Re

It's all about risk.

At PartnerRe, risk assumption is our business. Our success is wholly dependent on our ability to manage risk, so we focus first on the risk and then we consider the expected return.

– **Risk management is at the core of our value proposition**. We transform the uncertainty presented by risk into the certainty of claims payment for our clients. We must also produce an adequate return for our shareholders. Our challenge is to find the optimal balance between the returns that we can produce over the course of the market cycle and the risk to which we expose our capital.

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It's all about risk.

– Risk management is integral to our five-point strategy, which encompasses diversification, risk appetite, active capital management, excellence in evaluating and valuing risk, and consistency in how we deal with reinsurance and capital markets risks.

– Risk management is **embedded in our culture**, which encourages ownership and responsibility for risk management at all levels, with aligned return goals and compensation systems.

In the immediate wake of the Financial Crisis, PartnerRe decided to feature ERM in its 2008 Annual Report

PartnerRe Key Risk Policy Statements

1. We centrally set and monitor absolute limits on our exposure to our shock losses.
2. We employ a consistent pricing methodology for all of our risks.
3. We use retrocession sparingly.
4. We reserve the lead year of long tail lines with prudence and recognize the inherent volatility.
5. Our non-life and life reserves are supported by investment grade fixed income securities matched as to quantity, duration and currency.

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Source: PartnerRe 2008 Annual Report

PartnerRe Key Risk Policy Statements

6. We do not manage reinsurance or investment risks for others.
7. We manage our underwriting and investments internally.
8. We make acquisitions only when they can be bought at or below economic value and integrated.
9. Our invested assets will be held at market for liquid investments and at fair value for investments which require significant management judgment.
10. Management's best estimate of fair value will never be greater than the value recommended to the Group Valuation Committee.

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Source: PartnerRe 2008 Annual Report

PartnerRe Key Risk Policy Statements

11. The CEO and the EC are the only people who can speak for PartnerRe as a Group to external audiences on strategic matters.
12. All senior managers will be significant shareholders of PartnerRe.
13. We do not pay a "carry" or percentage of profits to any individual at PartnerRe.
14. The primary metric for our annual incentive will be ROE.
15. Our Key Policies and supporting processes are subject to internal audit annually to ensure that they are operating effectively as designed.

Source: PartnerRe 2008 Annual Report

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PartnerRe Risk Culture

Skilled people and an appropriate culture

- The people who put the strategy, methodologies and policies into practice are just as important as the framework.
- Our culture does not depend on "superstars," nor is it a "tick-the-box" environment that discourages individual initiative.
- We aim to find a happy medium that allows our people the flexibility to use their talent and exercise decision-making responsibility within the framework described. The emphasis on balance between qualitative judgment and quantitative analysis is reflected in the skill sets of our employees.
- Our underwriters and investment managers work closely with actuaries and analysts when making risk-assumption decisions.

Source: PartnerRe 2008 Annual Report

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PartnerRe
Since 2008

- Partner Re experienced a large loss in 2011
  - Due to Japanese and New Zealand earthquakes
- Here is a part of management's reaction:
  - *From a broader perspective, we are satisfied with the way our risk management systems performed.*
  - *Given the type of events, the losses were within our contemplated scenarios and <u>within our maximum risk appetite.</u>*
  - *But we also realize that <u>we can improve on the communication of our risk appetite and risk tolerances</u> as well as on our risk positions at any point in time – and we will.*

PartnerRe
2013 Annual Report

The limits approved by the Risk and Finance Committee and the actual limits deployed at December 31, 2013 and 2012 were as follows:

	December 31, 2013		December 31, 2012	
	Limit approved	**Actual deployed**	**Limit approved**	**Actual deployed**
Natural Catastrophe Risk	**$2.3 billion**	**$1.5 billion**	$2.3 billion	$1.6 billion
Long Tail Reinsurance Risk	**$1.2 billion**	**$0.8 billion**	$1.2 billion	$0.7 billion
Market Risk	**$3.4 billion**	**$2.6 billion**	$3.4 billion	$2.5 billion
Equity and equity-like sublimit	**$2.8 billion**	**$1.8 billion**	$2.8 billion	$1.7 billion
Interest Rate Risk (duration)—excess fixed income investment portfolio (1)	**6.0 years**	**1.5 years**	—	—
Interest Rate Risk (duration)—total fixed income investment portfolio (2)	—	—	5.0 years	2.7 years
Default and Credit Spread Risk	**$9.5 billion**	**$6.8 billion**	$9.5 billion	$7.1 billion
Trade Credit Underwriting Risk	**$0.9 billion**	**$0.7 billion**	$0.9 billion	$0.6 billion
Longevity Risk	**$2.0 billion**	**$1.2 billion**	$2.0 billion	$1.1 billion
Pandemic Risk	**$1.3 billion**	**$0.6 billion**	$1.3 billion	$0.6 billion
Agriculture Risk	**$0.3 billion**	**$0.1 billion**	—	—
Mortgage Reinsurance Risk	**$0.7 billion**	**$0.2 billion**	—	—
Any one country sub-limit	**$0.5 billion**	**$0.2 billion**	—	—

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Risk Culture

How it goes wrong
Examples from Insurance Industry

Dave Ingram, CERA, FRM, PRM

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10 things that we should have but didn't learn from Enron

1. Conflicts of interest continue to occur
2. If it's too good to be true, it probably isn't
3. Regulators and the regulated continue their dance
4. Transparency is vital
5. More capital is better
6. Excessive leverage is as dangerous as a bad bet
7. Corporate leadership makes all the difference in the world– for good and for bad
8. Preferred stockholders get preferred treatment
9. Still building fragile financial structures
10. Important names make mistakes too

40 Source: ABC News

10 things – The link to culture

1. Conflicts of interest continue to occur
2. If it's too good to be true, it probably isn't
3. Regulators and the regulated continue their dance
4. Transparency is vital
5. More capital is better

- See conflicts as always grey
- Believe we are smarter than everyone else
- See regulators as the enemy
- Knowledge is power – Operate on need to know
- Objective of Corporate Finance function is to minimize capital needed

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10 Thngs – Link to Culture

6. Excessive leverage is as dangerous as a bad bet
7. Corporate leadership makes all the difference in the world–for good and for bad
8. Preferred stockholders get preferred treatment
9. Still building fragile financial structures
10. Important names make mistakes too

- We are safe with the amount of leverage
- Our leaders are always looking out for the firm
- It is stock market performance that counts
- Our expertise is in building complicated structures
- Not ours

42 Source: ABC News

Reasons Civilizations Fail

from Jared Diamond
Author of “Guns, Germs & Steel”

1. Failure to anticipate a problem before it arrives
2. Failure to see a problem once it arrives
3. Failure to even try to solve a problem once they have perceived it
4. Failure to solve a problem that they are trying to solve.

ERM
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Reasons Civilizations Fail

1. Failure to anticipate a problem before it arrives
2. Failure to see a problem once it arrives
3. Failure to even try to solve a problem once they have perceived it
4. Failure to solve a problem that they are trying to solve.

Message from Culture

- Low value to imagination
- Shoot the messenger
- Not my responsibility
- Over-specialization

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Six types of risk management failures:

1) Mismeasurement of known risks.
2) Failure to take risks into account.
3) Failure in communicating the risks to top management.
4) Failure in monitoring risks.
5) Failure in managing risks.
6) Failure to use appropriate risk metrics.

Rene Stulz

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What we have here is a failure to Communicate…

"Specifically, it would appear that a subordinate who received a direct oral order from his boss had to figure out whether it meant what it seemed to or the exact opposite, while the boss, in conversing with a subordinate, had to figure out whether he should take what the man told him at face value or should attempt to translate it out of a secret code to which he was by no means sure he had the key."

John Brooks, "Business Adventures" describing the GE culture in the late 1950's

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Or maybe the intended message got through…

As part of its ethics activities, Enron created a Code of Ethics manual. Clearly, someone at Enron thought this was a great idea. And it was. Except that all 64 pages of the manual were disregarded on countless occasions.

Samantha Greves

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What is Risk Culture

- What is said about Risk
- What is done about Risk
- Driven by what is commonly believed about Risk

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Two ways for Culture to go wrong

Wrong Beliefs

- Usually beliefs about how Risky something actually is
- But might also be mistaken beliefs about what is sufficient to control risk
- Or mistaken beliefs about risk taking capacity of firm

Bad Faith

- Management is aware of actually riskiness, controls needed and risk taking capacity but willfully ignores that information for their own (and possibly shareholders) gain
- Management is negligent in allowing time and resources for risk management

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Six types of risk management failures:

1) Mismeasurement of known risks.
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6) Failure to use appropriate risk metrics.

Rene Stulz

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Insurance Company Problems

1973: Equity Funding Fraud	Bad Faith
1983: Baldwin United Shell Game	Bad Faith
1988: Equitable (NY) GIC losses.	Wrong Belief
1991: Executive Life / First Capital Life Junked	Wrong Belief
1991: Mutual Benefit Liquidity Squeeze	Wrong Belief
1991 – 1996: Lloyd's Asbestos Liabilities	Black Swan
1994: Confederation Life Failure	Wrong Belief
1994: Monarch Life Seizure	Wrong Belief
1997: US Market Conduct	Bad Faith
1997: Nissan Mutual ALM Failure	Wrong Belief
1999: Toho Mutual & Daihyaju Mutual	Wrong Belief
1999: General American Liquidity Failure	Wrong Belief
1999: Korea Life ALM Losses & Failure	Wrong Belief
1999: Unicover Fiasco	Bad Faith/Wrong Belief

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Insurance Company Problems

2000: Equitable UK Pension guarantees	Wrong Belief
2001: World Trade Center	Black Swan
2002: Conseco chokes on Green Tree	Wrong Belief
2002: HIH Surprise	Bad Faith
2002: Amer Skandia VA problems	Wrong Belief
2003: Allmerica VA reserving	Wrong Belief
2006: Hurricane Katrina	Wrong Belief
2008: AIG, Bond Insurers, VA writers bailouts	Wrong Belief/Bad Faith

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Palmieri's Laws

- **The law of collective incompetence:** In a board of directors, and their individual level of intellectual acuity and moral courage will immediately plummet to the lowest common denominator.
- **The law of the visionary leader:** The salesman genius who succeeds to top management is almost always too arrogant or too insecure to take financial guidance and too focused on making deals.
- **The law of sudden crisis:** It takes years of intensive effort by a determined management to create the conditions for the failure of a major corporation.

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Palmieri's Laws

- **The law of budgets and forecasts:** If prior leadership had build an honest management-information system, there would be no need for outside help.
- **The law of creditor relations:** The key to a successful reorganization is making all creditor groups equally unhappy.
- **The law of external effects** (California-style): In the end, macro factors tend to swamp micro factors.

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Conclusion

- When an individual gets it wrong
  - That may not be a culture issue
- Firms do collectively get it wrong
  - That is Culture
    - Wrong belief about risk
    - Bad Faith

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