

Practical ERM Considerations — From an Insurance Carrier's Perspective

by Steve McElhiney, CPCU, MBA, ARe, AIAF



Steve McElhiney, CPCU, MBA, ARe, AIAF, is president of EWI Risk Services Inc., a Dallas-based reinsurance intermediary and a subsidiary of NL Industries, a diversified industrial company. He also serves as president of Tall Pines Insurance Company of Vermont, an affiliated captive insurance company. McElhiney's insurance industry experience has spanned over two decades in roles such as CFO, corporate treasurer and ceded reinsurance executive. McElhiney currently is the CPCU Society's president-elect.

Editor's note: This is the second of a three-part series by **Steve McElhiney, CPCU, MBA, ARe, AIAF**, on enterprise risk management (ERM). The first installment was published in the July 2010 issue of *Personally Speaking*. In the third and final installment, he will sum up risk and underwriting considerations, such as exposure, rating, governance and ERM framework.

Enterprise risk management (ERM) requires a company to contemplate both obvious and less conspicuous forms of risk. As **Warren Buffett** has often said, "It is the unexpected risk that will get you every time, not what is widely expected." Thus, the highly anticipated "Y2K" or

"H1N1" exposures were, ultimately, non-events, while unanticipated volcanic disruptions or tsunami events have had a wide reaching and substantial impact.

We live in a world of unprecedented volatility. Oil has varied from \$150 per barrel to less than \$40 per barrel during a one-year period. Stock averages have seen substantial double-digit increases and decreases. External "shock" events are increasingly likely, and geopolitical events could conceivably bring the global financial markets to a crash within a 72-hour period through energy and supply chain disruptions. This is the "new normal." The old measures of evaluating and mitigating organizational risks have been transformed. New risk exposures seem to be surfacing by the day.

Across various industries, there are some common elements of risk in an ERM framework. These broader elements often transcend the common perils associated with traditional insurance solutions:

- Credit and counterparty risk.
- Traditional "insurance risks."
- Business interruption risks (primary, secondary and tertiary suppliers and customers).
- Foreign currency risk.
- Interest rate risk.
- Management liability risks.
- Commodity price fluctuation risk.
- Product liability and recall risk.
- Control risks.
- System risks.
- Investment risks.
- Political risks.
- Disaster recovery/business continuity risks.
- Obsolescence and marketplace risks.
- Human resources risks.
- Critical dependencies and supply chain risks.

- Terrorist risks (including eco-terrorism risks).

The incidence of such risks has a direct relationship to the organizational complexity and scope of operations. That is, highly disparate organizations that operate in a variety of countries have more inherent enterprise risk than domestically focused entities with specialized business models. All organizations, large or small, are subject to the vagaries of the overall economic system. As the financial crisis demonstrated, no industry or region was immune to its effects.

All forms of enterprise risk need to be assessed in the context of their likely frequency of occurrence and severity as to financial impact.

On an overall "macro" basis, however, it is clear that overall levels of risk are increasing with global interdependencies and tight supply chains. Further, the volatility associated with investments, currencies and commodity prices is unprecedented and subject to severe swings in capacity and shortages. The level of business complexity that exists will drive the level of enterprise risk exposures to new heights.

It is incumbent for a management team to continually monitor the external environment to contemplate the range of exposures and events, including potential outlier extreme events.

Property-casualty insurance carriers have a variety of sources of enterprise risks:

- Asset risks.
 - ♦ Investment holdings.
 - ▲ Concentration risks for both single issuers and by sector concentration.
 - ▲ Duration risks (the risk that long-term bonds may depreciate materially due to changes in interest rates).

- ▲ Bank concentration risks (given FDIC limitations at \$250,000 per institution).
- ◆ Asset/liability matching risk — does the overall duration of the investment portfolio effectively match the overall duration of the loss reserves?
- ◆ Investment reinvestment risk — the risk that maturing investments may not be able to roll over to equivalent yielding instruments at maturity.
- ◆ Reinsurance recoverable assets (both uncollectible accounts due to credit impairment and those that are uncollectible due to disputed cessions — the so called “can’t pay” and “won’t pay”).
- ◆ Premium receivables — the credit and execution risk associated with brokerage firms and potential concentration issues.
- Liability risks.
 - ◆ Loss development for long-tail lines of business.
 - ◆ Overall risk arising from its underwriting book.
 - ◆ Liability duration assessments.
 - ◆ “Leakage” associated with escalating defense costs and third-party administrator (TPA) fees.
 - ◆ Financial and operational leverage — is capital overly exposed in comparison to premium writings or insurance and financial liabilities?
- Off-balance-sheet contingent liabilities.
 - ◆ Letters of credit.
 - ◆ Loss-sensitive accounts — the unexpected ultimate premium less cash paid to date (for retrospectively rated policies) or the deductible portion reimbursable (for large deductible policies).
 - ◆ Life insurance (and structured settlement) annuities.
 - ◆ Material coverage disputes.
 - ◆ Litigation risks.
- Market risks.
 - ◆ Premium adequacy.
 - ◆ New product development and related execution risks.
 - ◆ Distribution network risks due to aggregation issues and potential market disruptions.
 - ◆ Tax law changes — unexpected changes to both the U.S. corporate tax scheme and/or changes to state-levied premium taxes constitute a material source of risk.
 - ◆ New forms of product distribution that could affect traditional pipelines (such as new Web-based platforms and related market entrants).
- Macro-economic risks.
 - ◆ Economic trends can adversely impact ratable policy accounts — across an entire underwriting portfolio — markedly. This is most pronounced in very economically sensitive segments such as workers compensation or commercial auto and trucking.
 - ◆ Reinsurance availability and capacity — both are a direct function of industry underwriting results, catastrophic events and adverse investment trends. Further, the increased concentration of reinsurers could lead to potential capacity availability issues for certain lines of business in certain regions. It is possible that sudden increases in reinsurance rates may not be fully supported at the primary-insured level due to regulatory constraints on underlying filed rates; thus, margin pressure (and potentially unacceptable pressure) may ensue that greatly constrains the viability of the company.
 - ◆ Regulatory risks — the state-regulated insurance industry may be facing some heightened oversight from the federal government; a model may be evolving where the states are responsible for pricing and market conduct and the federal government will take an enhanced role in solvency regulation. Title V of the Dodd-Frank Wall Street Reform and Consumer Protection Act provides for the establishment of a Federal Insurance Office and mandates a study and report be issued no later than Sept. 30, 2012, that examines the breadth and scope of the global reinsurance market and the role it plays in supporting insurance in the United States. The report is required to examine matters such as systemic risk regulation; capital standards and the relationships between capital allocation and liabilities; and related reserving practices and additional consumer protection mechanisms focused on gaps in state regulation. From an international perspective, the G20 countries widely endorse a similar regulatory framework. Clearly, regulation and oversight in the insurance industry will be increasing.
- Litigation risks.
 - ◆ Adverse tort trends in various jurisdictions.
 - ◆ Emerging issues related to mass tort actions and the risk associated with piercing various years of coverage under occurrence policies. ■