Emerging practices in risk tolerances

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Insurers have long embraced the concept of risk tolerances. In some cases, the risk tolerances were expressly stated in a company's enterprise risk management (ERM) policy document or in other cases exhibited in the course of normal operations.

Beginning in 2015, the insurance industry changed its risk tolerances focus and transitioned to the development of more formal statements and transparency on the timing of company actions. The A.M. Best 2014 Supplemental Rating Questionnaire (SRQ) introduced a question on companies' risk tolerances and board involvement. The question appeared again in the 2015 SRQ and is expected to remain in the SRQ as part of the company regulatory practice section and evolve further in the next few years.

Risk tolerances are a fundamental component of a company's formulation of its "Own View of Risk." A company's view of its catastrophe models and model suitability analysis also encompasses its "Own View of Risk." It is becoming increasingly important for companies to take an independent, customized view of how they see risk and the timing of company actions taken in response to risk. The explicit articulation of risk tolerance statements and use of model suitability analysis in catastrophe models reflect a transparent and specific approach to how risk is defined and viewed – an opportune development that may lead to deeper internal and external discussions on how each company views its risk.

The development and maintenance of stated risk tolerances are critical because they touch on all aspects of a company's operations. Risk tolerance discussions characteristically involve underwriting, marketing, claims, information technology, rating agency strategy, board communications and reinsurance functions. The all-encompassing nature of building risk tolerance statements gives them tremendous value. Risk tolerance statements compel management to think about all aspects of the business and the unique and specific impacts the statements have on the business.

As A.M. Best implements a new rating methodology with ERM as a specific rating category, risk tolerances will play an increasingly important role with the potential to further differentiate risk profiles in Best's evaluation of companies ' risk and capital needs. Risk tolerances will likely positively impact a company's ERM evaluation when A.M. Best deems the company's risk tolerances as adequate and appropriate.

Risk tolerance statements have four major components:

- Metric, for example net income or surplus;
- Value, for example five percent or USD 10 million;
- Probability, for example "not greater than ten percent or 20 percent"; and
- Element of time, for example one year or three months.

The probability component of risk tolerances and the need to understand potential capital outcomes prompt companies to use economic capital modeling. This process brings the company closer to its "Own View of Risk."

We expect that eventually a specific company's "standard" for risk tolerances will emerge. As more companies articulate their risk tolerances the industry will migrate to an accepted set of principles on which risk tolerance statements are built. Guy Carpenter believes that one of those principles may be "response policy," which will dictate the value and probability used for a risk tolerance statement – at what value or number or probability will the company take action? What type of action will the company take? Will the action be far reaching or preventative? The response policy principle may provide guidance to companies in answering these difficult questions and ultimately help form the companies' "Own View of Risk."

Guy Carpenter is focused on the future and continues to invest in innovative resources and expertise to add client value. We help clients develop risk tolerance statements that align with their "Own View of Risk" and key stakeholder expectations, and are supported by a robust capital modeling platform.

Our extensive experience with risk tolerance consultations and access to public data enables us to create custom benchmarks of industry practices. Guy Carpenter's BenchmaRQ® and MetaRisk® are robust capital modeling solutions to help companies validate their risk tolerance statements and ensure alignment with key risk limits within their organizations. ●