Stop moaning and deal with it!

Feeling sceptical about Enterprise Risk Management (ERM)? **David Spiller** spells out its many benefits for insurers and reinsurers

David Spiller is president and chief executive of Guy Carpenter.

In my travels in the past year, as I got to know Guy Carpenter's clients, I heard a number of grumblings about the new regulatory regime of Enterprise Risk Management (ERM). For many (re)insurers, ERM is viewed as a regulatory burden that layers an unnecessary bureaucratic function onto the organisation.

Some insurers fear that they will not gain anything new from ERM. In their view, it represents the restatement of obvious facts and standard practices. In general, capital modelling is frequently viewed as a costly exercise with very little benefit.

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It is human nature to resist change. We are creatures of habit, and generally prefer the tried and true as opposed to what is new and experimental.

Modelling and ERM

In my view, a parallel situation existed for natural-catastrophe modelling prior to Hurricane *Andrew* in 1992. Despite herculean work by early pioneers, the modelling approach was restricted to a mere handful of enthusiasts. Nowadays, catastrophe models are so entrenched in both the vernacular and practice of catastrophe management that a failure to describe a company's modelled loss at benchmark return periods would be judged as definitive evidence of gross mismanagement.

Why the change? Hurricane *Andrew*'s unprecedented losses revealed fatal flaws in traditional actuarial approaches to rate-making and underwriting, thus providing an easy entry for the newer model-based approaches.

While the continued pressure from regulatory and rating agencies will compel the adoption of ERM, this will take time. In the interim, skeptical insurers and reinsurers may wish to review the general benefits their company can accrue from adopting ERM. This review may lead them to be more enthusiastic for the approach and thus facilitate the inevitable move to an integrated ERM company environment.

Firstly, ERM tends to increase internal risk awareness. One of the great benefits of internal modelling is that it allows managers to experience the future. Through detailed and sophisticated modelling, management can 'live' a projected future environment. Through this exercise, they can acquire detailed knowledge of how various scenarios can impact the company, allowing decisions to be made in a more informed and knowledgeable way.

Secondly, ERM promotes the documentation of decision-making for internal and external stakeholders, which in turn encourages a more scientific assessment and management of risk, with hypotheses subjected to detailed testing.

ERM need not be an additional bureaucratic layer. A 'risk function' is often like scaffolding —initially the scaffolding is essential to support the building in the early stages of the construction process, but once the building can support itself and can handle the movement of workers, materials and machines, the scaffolding is no longer needed and can be removed. Similarly, once ERM is ingrained in an organisation, it becomes redundant as a separate unit — instead, it morphs into a core means of how the business functions.

Decision-making aid

Another benefit of taking an active approach to ERM is that by using the services of an internal risk model, companies can make active risk-reward evaluations and portfolio-management decisions. More generally, ERM represents the encoding of sound business practices into the basic DNA of the organisation. Who can argue with transparency, objectivity, openness, communication and discipline? The capabilities created from the implementation of enterprise- wide risk management can be used defensively (as in compliance) and offensively (as in active portfolio management).

The adoption of ERM can be seen in the more general arena of management and its ability to make better-informed decisions. In this context, the management guru, Professor Jeffrey Pffeffer of Stanford University, has argued for top management to pursue what he calls evidence-based decision-making.

In an article in the *Harvard Business Review* in January 2006, Pffeffer argues that top management makes more than 80% of its decisions without much use of the readily available evidence. He finds that management frequently uses personal experience in making its decisions. Pffeffer argues that managers should "put aside belief and conventional wisdom, and replace these with unrelenting commitment to gather facts and to make more informed and intelligent decisions." Such an approach ties in neatly with the ERM discipline, given its focus on informed decision-making.

Overall, the adoption of ERM is inevitable at both the rating and regulatory levels. Faced with this fact, I would suggest a strategy of enthusiastic support for ERM, particularly in those areas where there is clear and immediate benefit to managers' information base and to the quality of the company's decision-making. re

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