If you want to get ahead, learn from your bank

David Spiller, president and chief executive of Guy Carpenter, looks at what we can learn from the experience of our cousins in the banking industry

David Spiller is president and chief executive of Guy Carpenter.

In October 2005, Standard & Poor's (S&P) Rating Services included a formal evaluation of insurer enterprise risk management (ERM) in its rating process. This confirmed what had been anticipated for years: that the discipline of ERM would migrate from banks to other sectors of the financial services industry.

ERM is concerned with identifying and managing the critical risks facing a business. It is important to understand that ERM does not represent something new for insurers. Rather, this is an evolutionary step for our industry. ERM includes traditional practices, such as monitoring of exposure accumulation, controls on pricing, reserving and audits — the basic elements of sound risk management for an insurer.

The evolutionary step forward into ERM will involve treating all risk sources in a proactive and integrated fashion, with the goal of improving stakeholder value of the firm. To make this leap, insurers must embrace comprehensive risk management fully. Many insurers do a good job of this in certain segments of their business, for instance, catastrophe-exposed property, but the whole industry could learn from the experience of similar industries that are further along the ERM learning curve.

So, what can property/casualty (P&C) insurers learn from the banking industry? For banks, the evolution into ERM represents advancement in credit market discipline, with the results being improved transparency, efficiency and reliability. Market participants would not have willingly invested the time and money without sufficient impetus, such as: repeated market crises; investors seeking greater transparency and reduced losses; regulators wanting to know that creditors were not overextended; and creditors seeking assurance that borrowers could honour their obligations.

A closer look reveals a number of strong similarities between banks and P&C insurers. For example:

(1) Banks face catastrophic economic consequences from the correlation of defaults arising from severe economic downturns. Insurers face catastrophic losses from correlated losses, arising from both natural and man-made hazards.

(2) Third-party debt ratings are key drivers of the market cost of credit, but lenders expend enormous energy looking for additional rating criteria to identify and exploit market mis-pricing. For insurers, past or projected loss ratios are basic drivers of rates and underwriting. Similar to banks, insurers commit considerable resources to identifying favourable underwriting criteria, such as developing credit scoring.

(3) Borrowers care about their track records (credit history) because they rely on continued access to the debt markets. On the insurance side, policyholders are focused on their loss records, as they are a key driver of insurability and cost of cover.

(4) Regulators impose risk-management constraints to ensure that lenders are not over-leveraged. In insurance, some regulators have moved to risk-adjusted standards to ensure insurers are not overextended relative to their risks.

Clearly, the risk-management challenges in P&C are not dissimilar to those in banking, and insurers can benefit from their experience.

What to learn

A quick overview reveals the following lessons from the banking industry's experience with ERM:

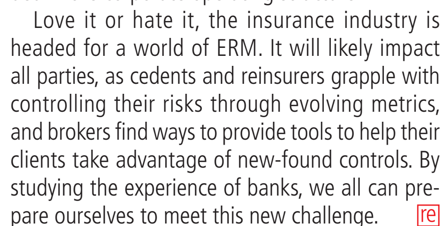
First, the need for quality data is high for most credit-market instruments. Market discipline means that no competitor transacts without the minimum acceptable information. It is imperative that no 'lowest common denominator' undermines market discipline. Who could deny the need for better-quality data in P&C insurance?

Second, focus on counter-party risk, particularly for potential exposure accumulations under stress scenarios. Insurers must ensure their reinsurers are not overexposed in risks transferred by the cedent — a cedent transferring California quake would want to know the reinsurer's exposure to this.

Third, manage both individual transactions and aggregate portfolio metrics. Neither is sufficient on its own. Insufficient focus can increase the exposure to the portfolio and firm.

Fourth, develop more robust secondary markets — securitisation has transformed the net risk profiles of many lenders. Data quality and contract standardisation are essential prerequisites. Agreement again is from the insurance industry. Securitisation has made slow progress in insurance, but with new forms of risk transfer emerging, we are entering a more dynamic era where new methods of direct transfer of risk to investors will multiply.

Fifth, embed ERM in the critical business decision-making process. Sophisticated, well-run lenders are disciplined in their limit-setting, monitoring and enforcement, portfolio-risk modelling, pricing models and model validation — all key elements of sound portfolio-risk management. (Re)insurers know business practices like ERM must be embedded in the corporate operating structure.



Love it or hate it, the insurance industry is headed for a world of ERM. It will likely impact all parties, as cedents and reinsurers grapple with controlling their risks through evolving metrics, and brokers find ways to provide tools to help their clients take advantage of new-found controls. By studying the experience of banks, we all can prepare ourselves to meet this new challenge. re

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