Successful Risk and Capital Management

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For insurance companies, the road to successful risk and capital management entails having a measurement model that is not overly complex, the backing of the top management, appropriate changes in the compensation plans, and organizational change. *The Geneva Papers* (2005) 30, 60–64. doi:10.1057/palgrave.gpp.2510013

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The capital bases of many insurers were depleted by the combination of the 2002 stock market decline and persistently low yields on all bonds (and high-profile defaults on some). These in turn exposed significant shortcomings in risk and capital management at most insurers. Management, as well as our Boards and regulators, have had to face up to their organization's inadequate understanding and quantification of the economic risks their businesses were taking on.

There exists today a fundamental business imperative to regain this understanding. It is this imperative, not Solvency II or impending accounting changes, that is driving the insurance sector to look again at its risk and capital frameworks. And for this reason, the revised and refreshed frameworks that result will have an impact far beyond regulatory and reporting compliance. They will fundamentally transform the way we do business, and, eventually, the competitive landscape.

Of course, such major change does not happen automatically. Fortunately, there is a huge body of literature covering the principles of successful change management. Many of these principles apply to changing risk and capital management frameworks. However, there is one extremely important difference with respect to insurers: risk and capital management is the core of what we do. It is how we meet our customers' needs and create value for our shareholders. This means that textbook solutions will not suffice.

What is successful risk and capital management?

At the highest level, a firm's risk and capital management framework can be considered a success when decisions change – for the better – across a range of subjects and at various levels within the organization.

At group level, this begins with executive management having a better picture of how much capital it is putting at risk and how much return is being/will be achieved in which business units. It further lays out whether these risks and returns are justifiable in terms of the firm's current balance sheet, target solvency standard, and risk appetite. This leads ultimately to better decisions that go to the core of how group management creates value – by answering the big capital allocation questions: Where should we invest our capital? Where should we grow? And where shrink?

But between this group-wide picture of risk profile and capital usage and the big, value-creating decisions lies a set of processes that also have to change, in some cases significantly, for the risk and capital management framework to be considered a success: planning; product development (critically including pricing); strategic asset allocation; and, above all, performance assessment and executive compensation. Some of these processes initiate in the business units, others at group level, but all of them require the involvement of both business units and groups.

A final characteristic of a successful risk and capital management framework is that it is perceived as such, and not just within the firm, but crucially also with rating agencies, equity analysts, and regulators. Increasingly, these external stakeholders will evaluate us as managers in relation to the effectiveness of our risk and capital management frameworks, with a more direct impact on market value than ever before.

The challenge this poses is considerable. The frameworks are complex enough for internal management to grasp; making them transparent to the outside world is an even more formidable task. As just one example, global players like Zurich Financial Services need to manage their capital in line with internal management structures. Regulators, on the other hand, have to use legal entities as the basis of their oversight.

The road to successful risk and capital management

If what has been said is an accurate picture of what a successful risk and capital management framework looks like, how does a firm get there?

As stated above, part of the answer is to be found in the well-documented list of key success factors that apply to any major organizational change programme: executive sponsorship, business unit involvement, and communication (just to mention a few factors). Rather than repeat what we already know on this subject, I would like to share some of our insights at Zurich regarding what makes transforming a risk and capital management framework different, and therefore deserving of special attention.

Get the balance right between measurement sophistication, on the one hand, and intelligibility/relevance on the other

Implementers should be wary of *overly complex* methodologies, not only because people are less likely to use something they do not understand, but also because complicated calculations are more difficult to repeat and audit on a regular basis. Related to this is the fact that calculations should be easily *replicable and repeatable*. Not only should the results be consistent period-to-period but the mechanics of the calculation should not be so onerous as to require substantial work in the business units. Models and data requirements should as far as possible be integrated into existing systems and processes.

Having said that, over-simplification is also a pitfall: at worst it might lead to seriously value-destroying management actions; at best over-simplification will lead to the framework being discredited, and thus ultimately undermined, by key technical staff in the business units. One reason why most insurers did not get their risk and

capital management frameworks right the first time is that they did not achieve this balance. If our industry is now in phase two of revisiting these frameworks, then the first item on the agenda is to shine a spotlight on the measurement system itself, its degree of complexity, and whether that complexity delivers substantial benefits – in the form of different decisions – in relation to the costs involved.

Create a “coalition of change” to lead the transformation – and look for them several layers below the CEO

There is a limit to how far a Chief Executive Officer (CEO) can drive any major change programme on his own, or even through his top team. He always faces a phase two problem: how do we propel change forward beyond the initial platform-building achievements? But this problem is made more acute in the case of risk and capital management for two reasons. First, there is the unavoidably specialized technical skill and expertise involved at the heart of such frameworks. This makes it difficult for senior general management to assess whom to populate the coalition with – and it is key in doing so that the *presiders* be kept on the side, and the *doers* be engaged. Secondly, this expertise does not sit on the Executive Committee, and is not always easy to discover on the firm’s organization charts: the expertise may be three, four, or five levels down in the organization.

The critical phase two change agents sit in the group and financial, actuarial, and investment management units. They must become true believers, pointed in the same direction as senior management, and empowered to drive toward the new system. The CEO and Chief Financial Officer (CFO) need to locate these people and find ways to communicate with them, regularly and face-to-face.

The risk, if you do not get this right, is that the foot-soldiers of risk and capital management – the ones without whom nothing happens – perceive the change as simply an extra workload. This puts them at risk of demotivation, at best, and of leaving the firm, at worst.

Change the pay plan at the earliest possible time

What gets measured and hits pay does change management behaviour. It is not simply that personal compensation is a motivator. Key staff from actuarial, finance, and investment management can become apostles, inspired by the CEO and CFO’s vision of a new risk and capital management business model, only to lose their enthusiasm as they see no follow through in the form of change in how business units and their managements are measured and compensated. CEO commitment is not seen as genuine if line managers still have incentives based on the old accounting earnings metrics, or if the CEO is overly worried about moving away from the old metrics because they are still used by the market to judge performance.

At Zurich, we changed the incentive structure in line with these observations. Rewarding performance *and* behaviour is one proven way to drive change through the whole organization.

Focus organizational change beyond new positions and new committees to new decision making and action

To move to successful risk and capital management will almost certainly involve some organizational change. But restructuring – new committees, new group functions, for example – is only a starting point. Often it is unclear whether the new positions/committees are supposed to take decisions, make recommendations, conduct analysis, or simply exchange information. But even if the organizational mandates are clear in everyone's mind, there remains a curious, stubborn resistance to taking action on the basis of new risk and capital management tools.

As an example, let us say it has been decided to allocate less capital to market risks, perhaps to reduce total capital usage, or perhaps to reallocate capital to other areas, for example, technical risks. How do we implement this decision? Most insurers have an Asset and Liability Committee (ALCO) in place; if not, then some other body performing ALCO functions. Suppose that ALCO decides to implement the Executive Committee's decision by reducing the equity allocation in a country from 30 per cent to 10 per cent. This instruction is communicated, and both ALCO and the CEO move on to other things. End of story? Too often, no.

The instruction sounds simple, but in practice its implementation may be vastly more complex and subtle than first meets the eye. For example, if the country is to reduce its equity holdings, which portfolio(s), in which business unit(s), over what period of time, and how (e.g. straightforward sale or derivatives) should such a reduction be accomplished? The answers are not self-evident, and indeed may have significant local regulatory implications. Consequently, the actual portfolio rebalancing may remain "pending" for many months after the Executive Committee believes it has reallocated its capital.

Certainly Zurich (and I suspect we are not the only company) has some work to do. Our approach is to apply new risk and capital management tools as early as possible and not wait for them to be perfect to the fourth decimal place before doing so. This has the advantage of giving directional insights and at the same time highlighting areas of weakness in the framework that need further attention. In this way, we build confidence in the new framework by refining it in action over time. This approach generates a by product benefit: it tells everyone in management that when it comes to risk and capital management, sitting on the fence is not an option. They are either part of the solution – making it a core competency – or they become part of the problem.

Reassert central control of (selected) capital management actions

Most global insurers have decentralized business models that correctly derive from the fact that insurance is a country-specific business, with reinsurance and the corporate customer business an exception to this rule. It remains true today that most of a global insurer's value is created in the business units where thousands of risk-related decisions are taken on a daily basis.

On the other hand, the world has changed significantly and I think permanently with respect to the capital that those decisions are putting at risk. In this new world, capital has to be owned by the group, and everyone in the organization must

understand and support this principle. Capital ownership means not simply the historical responsibility for raising funds, but also measuring, allocating, and evaluating the usage of capital, on a new risk-adjusted basis that overcomes the inadequacies of the old metrics.

Conclusions

There may be some in the senior management of insurance companies who still question the need to enhance the existing frameworks for risk and capital management. After all, they might argue, actuarial science and traditional accounting systems have sufficed for decades, and one cannot blame them for the external shocks to insurers' capital coming from capital markets.

In my view, this argument is not correct. There is ample recent evidence that the financial management of insurers falls far short of what shareholders and customers have the right to expect – especially as we are supposedly experts in the risk business.

Clearly, regulators, rating agencies, and equity analysts are all converging on the view that the need for change is not a question of whether but when. And we as senior management (not to mention our Boards) are increasingly being held to account for our companies' risk and capital management frameworks. Moreover, since we are insurers, not widget manufacturers, such frameworks will be used, not just as a box-ticking exercise for avoiding downside perils, much as internal audit is. Rather, the outside world, our own staff, and eventually our customers will judge us by the risk and capital frameworks we have in place, as a yardstick for how well we perform the basic insurance functions of evaluating risks, pricing them, taking them on (or avoiding them), and managing them.

For that reason, the attempts under way to radically improve risk and capital management frameworks will alter the competitive effectiveness of the insurance sector – but only where such attempts achieve a significant degree of success. As banks have already demonstrated, in today's financial services marketplace, the winners will be those that develop an understanding of the risk their firms are facing and consequently embrace a comprehensive risk and capital management as a core business competency throughout their organization.

It is the role of the Chief Executive Officer to ensure that this actually happens.

About the Author

James J. Schiro is Chief Executive Officer of Zurich Financial Services. He joined Zurich as Chief Operating Officer – Group Finance in March 2002 and at the same time became the Member of the Group Executive Committee. He was subsequently appointed Chief Executive Officer of Zurich in May 2002.