

Biennial Convention 2007

# Adventures in Risk

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# Enterprise Risk Management for P&C Insurance Companies

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## Purpose of Paper

**The intention of this paper is to explore the Landscape of Enterprise Risk Management (ERM) Theory with a focus on application of ERM in the key risk area for general insurers of commercial Pricing and underwriting.**



## Introduction/Agenda

***“...I define an executive’s job in 3 broad areas:***

- 1. Communicating the Territory**
- 2. Building relationships and facilitating interactions**
- 3. Producing results and outcomes”**



## Section 1

# The Enterprise Risk Management (ERM) Territory – The context

**“The man who is tenacious of purpose in a rightful cause is not stricken by the frenzy of his fellow citizens”**

**- Horace, 1st Century BC**



# Model Framework to Summarise Issues

Judgement

### 3. Tasking – Clarity of Goal

Includes:

- Right *goal* (knowing what we want for stakeholders- the ideology)
- Right *instructions* (knowing where to ‘draw the line’) – eg price v volume, exposure limits, etc.
- Right *resources* (clarity of right people and systems to achieve goal)

Frequently summarised as ‘*discipline*’ and clarity of where to ‘draw the line’.

### 1. Technical – Know How

This includes data, risk pricing and analytics firepower. It is a competitive disadvantage to be behind the market but sophistication in this quadrant alone will not create a long term sustainable competitive advantage. The sophistication in the commercial market is increasing with increased focus on exposure data and technical tools.

Intangible

### 4. Trusting – Congruency to goals

A broad approach and not ‘binary’ around price and technics. The non binary approach saw a range of possibilities and ‘finding a way’ to optimise. Key mentions were around: Right *Empowerment* - Point of sale underwriting support, education, authorities, licensing and career paths. Right *Spirit* – mentions made of ‘trust and verify’, ‘welcoming of scrutiny’ and ‘learning’.

In short – ‘Culture’.

### 2. Tending - Applying the Know How

Characteristics included close ‘centre’ and ‘point of sale’ underwriting communication. Best Practice showed willingness to try things on a small scale, learn from these attempts and adapt. There was strong awareness of actual price v target price and growth at segment level coupled implementation of actions from lead indicators. ‘Adapting’ and ‘lead indicators’ were key words heard when asked about best practice.

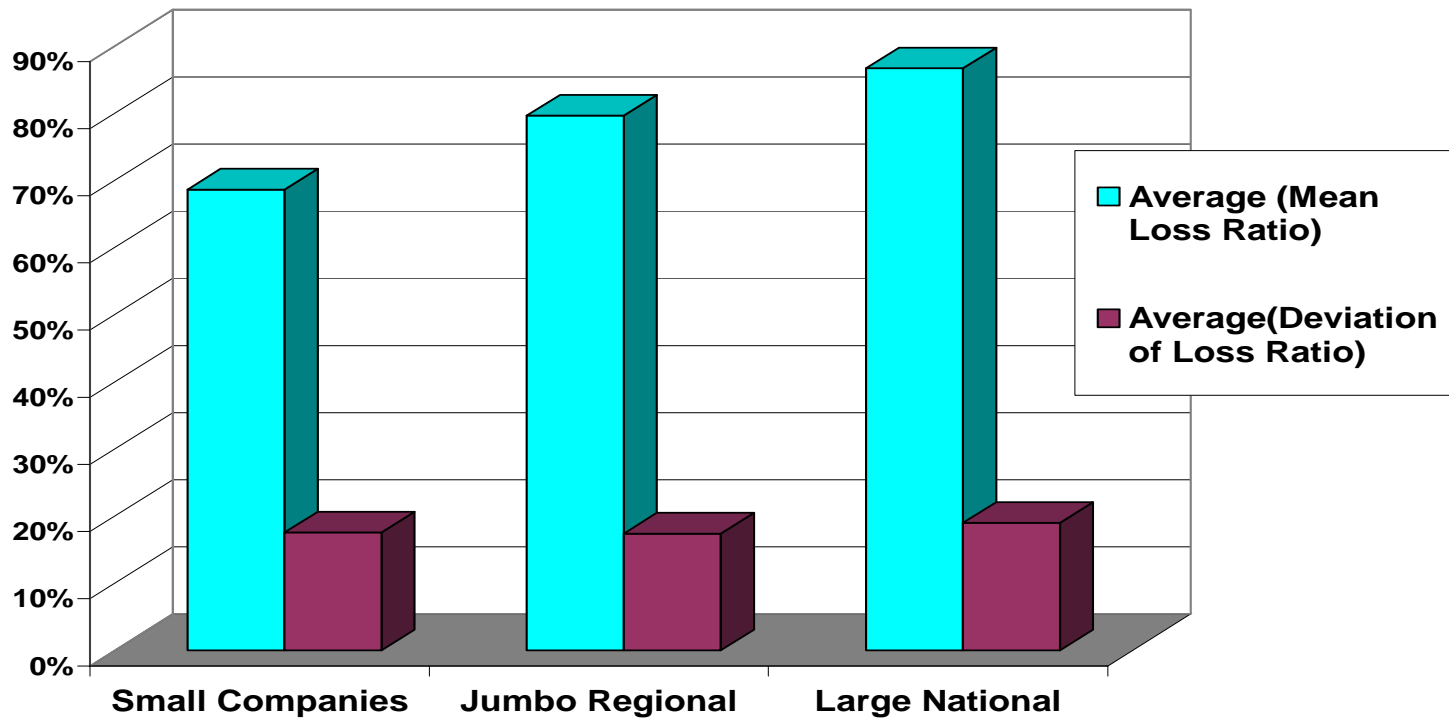
Tangible

Execution/  
Implementation



## Summary Result by Company Type

Workers Compensation: Loss Ratios By Company Type





## Net Effect of Diversification Benefit/Penalty

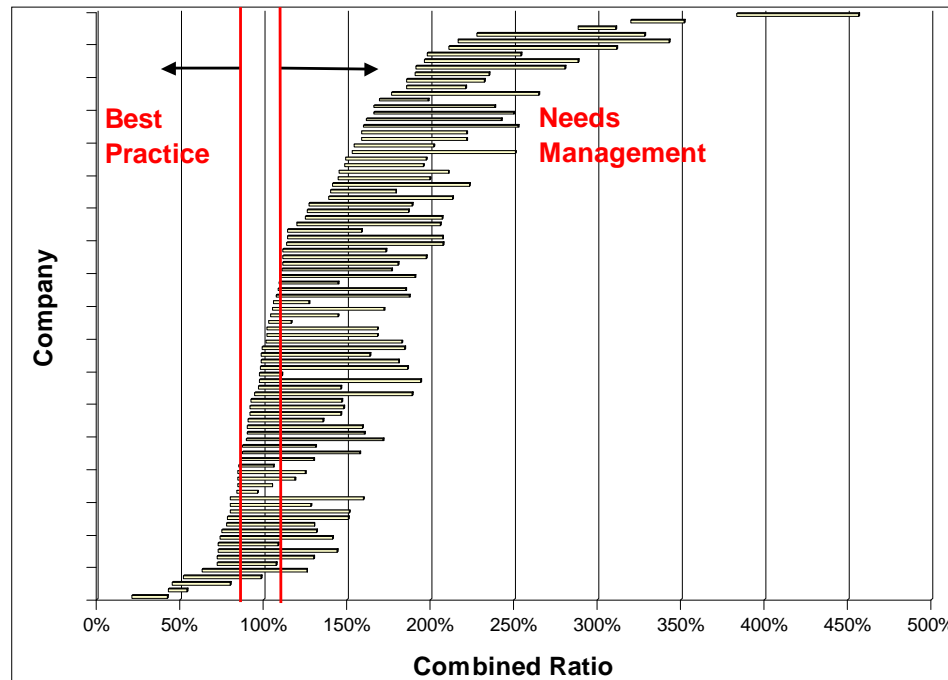
**It depends on the nature of business model,  
& how you conduct the business**

- Personal Lines: diversification essential for managing catastrophe exposure
- Commercial Lines: we observed dramatic differences in financial performance among companies with different underwriting/pricing practices



# GenRe Analysis-Combined Ratios By Company 1996-2006

Range of Combined Ratios By Company 1996-2006  
(Eliminating Extreme Values)



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## Section 2: Building Relationships and Facilitating Interactions

*“The possibility conversation focuses on what we want our future to be as opposed to problem solving in the past... This frees people to innovate, challenge the status quo and create new futures that make a difference” – Peter Block*



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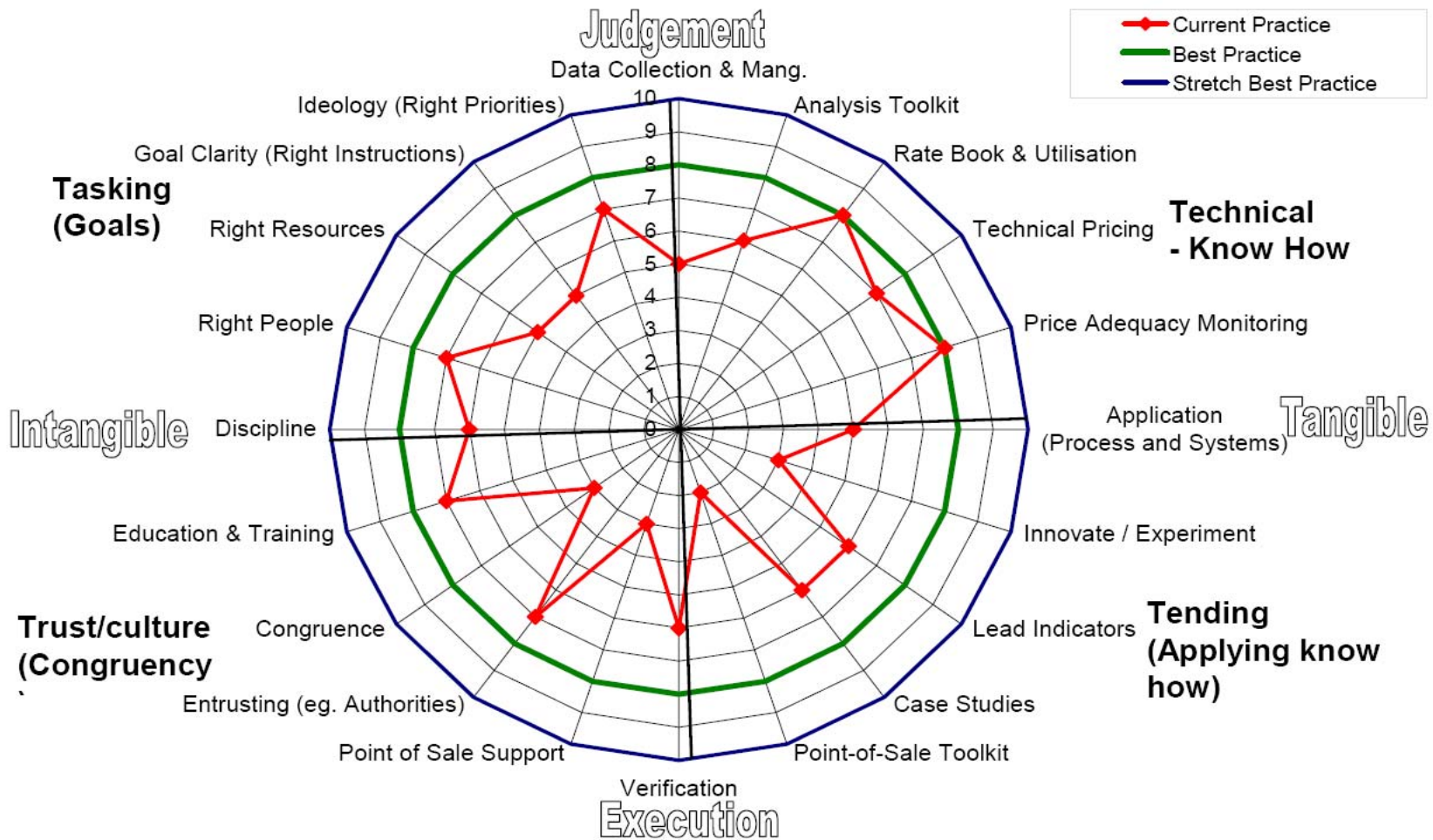
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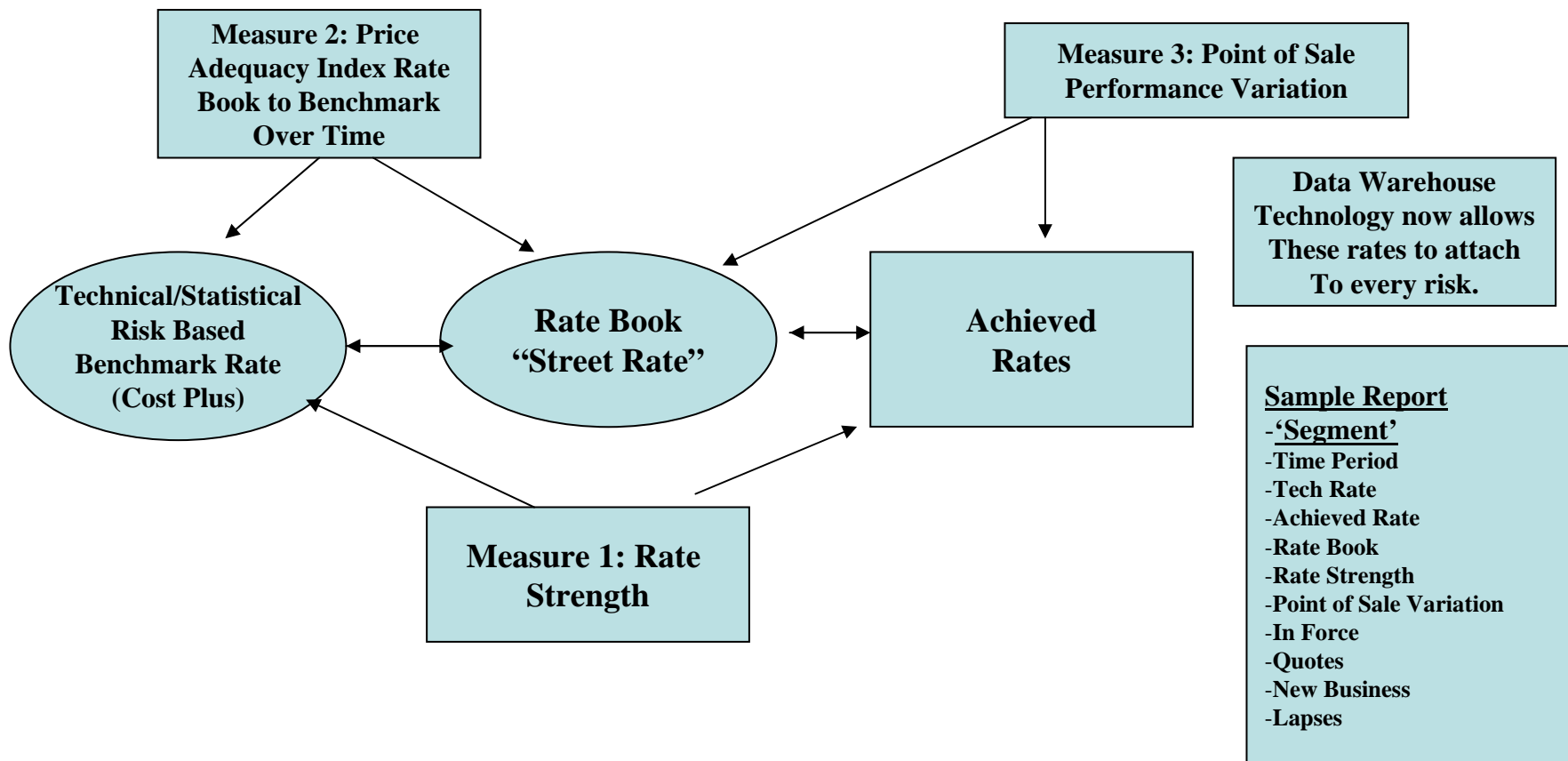
## Best Practice Pricing Risk Radar





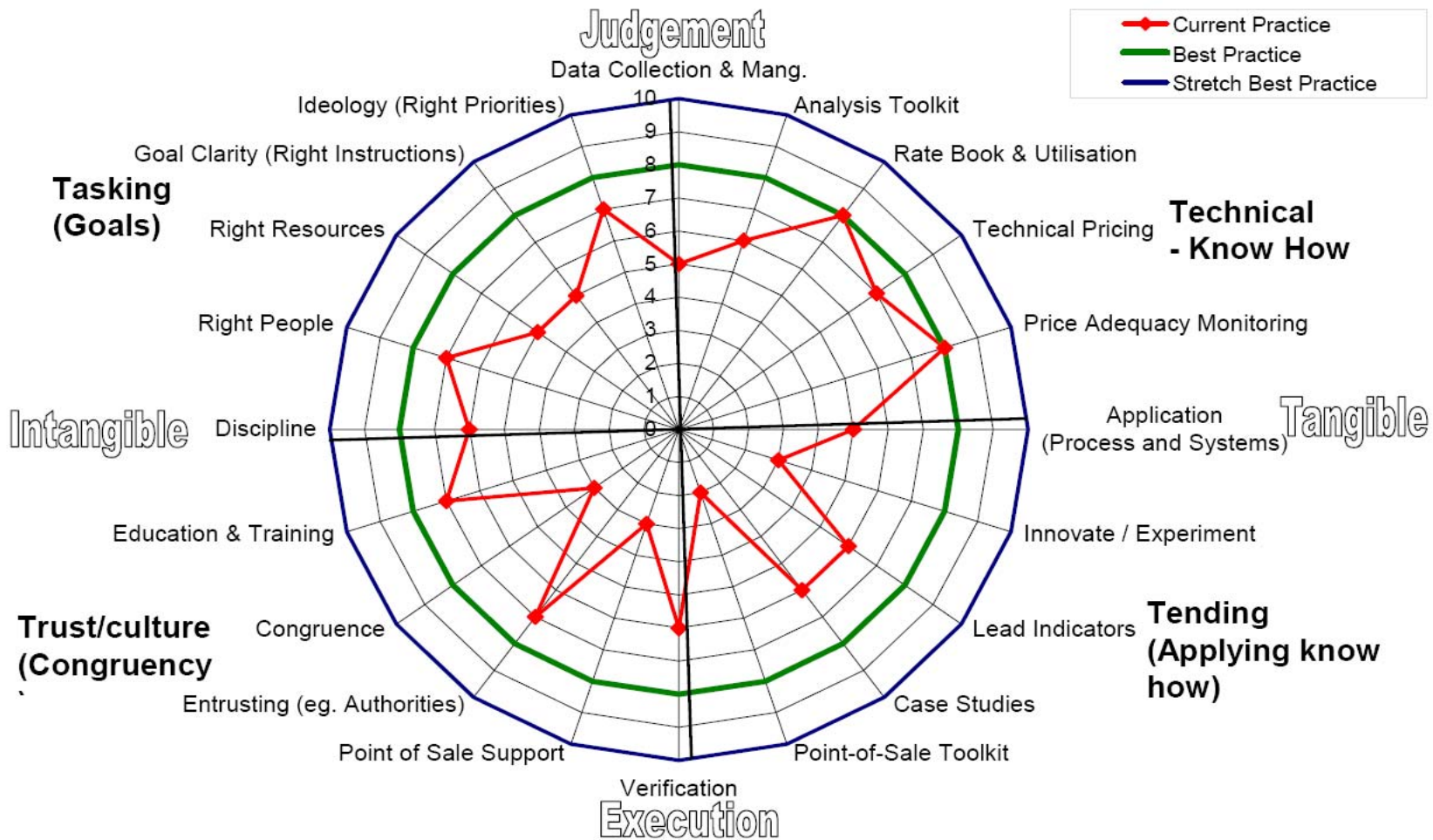
## Pricing Framework

**Pricing Framework –**  
Many interviews had different definitions but generally a theme around the Following:





## Stories from each quadrant..





## 3. Producing Results and Outcomes

*“T.E Lawrence (of Arabia) aphorism that ‘Making war upon insurgents is messy and slow, like eating soup with a knife’ is difficult to appreciate until you have done it...Knowing how to win is a different thing from implementing the measures required to do it” – John A Nagl.*



**“In my day we didn’t read many books, but we hit hard”**





## Leading Indicators vs Lagging Indicators

- **Reserves can only be a lagging indicator.**
  - at 12 months, are almost never in an adverse position to precipitate big change.
  - 24-36 months at best for true indications.
- **Rate change indications on renewal are adequate only if:**
  - constant policy form (SIRs, deductibles, limits etc) dominates the book of business and
  - policies are rated on a true exposure basis, and
  - new business constitutes a small percentage of premium.





## Lead Indicators – the 3 “must-haves”

1. Portfolio Volume
2. Premium Rate Adequacy
3. Portfolio Claims Performance
  - a) Claim frequency / per exposure
  - b) Average Claim size
  - c) Loss Ratio

**Attritional/Working Losses**

**Large (greater than a threshold)**

**Event claims (accumulated from single event)**



## Beware the “Winner’s Curse”

**“Mispricing has an insidious dimension called the ‘winners curse’, because the likelihood of ‘winning’ severely underpriced business is many times the hit ratio for fully priced business. Underpriced business may represent 5% of quotes but 20% of your portfolio.”**

McKinsey&Company, The Journey Revisited, 2004



## Entrepreneurial Underwriting



Brokers

Sales & U/writing

Understands holistic impact of decisions.

Innovates and Adapts – uses endorsements and RI to control risk and carefully monitors key indicators.

Access to full “toolkit” of info required to do the right deal (not just book rate).

External focus; looking for new opportunities.

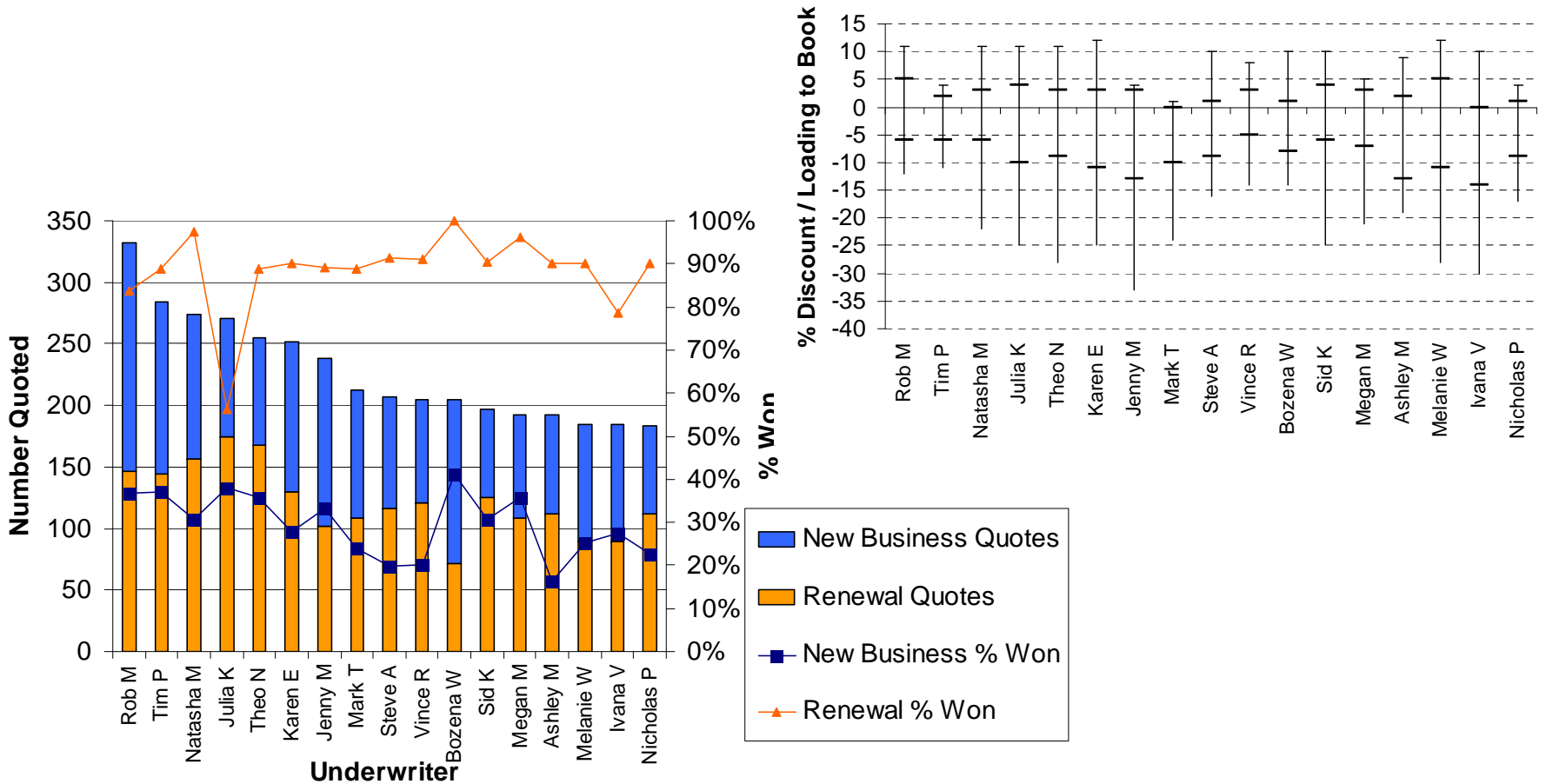
Follows up why quotes are not won. Looks to compete on more than price.

Efficient Processes – spends time where it makes a difference.

Case studies – large claims, legislative changes.



## Are Underwriters Abdicating Responsibility to Book Rates?





## Underwriting Psychology (from an Underwriter)

- Underwriting psychology is more important to understand than underwriting philosophy.
- Most underwriters think frequency more than severity. It is more tangible.
- Most underwriters have not been in the position long with their tail. The adverse development always belongs to others.
- Especially in larger companies, underwriting is not a career path, management is:
- Underwriters learn the unwritten rule early: No matter what management says, those with bigger books of business get rewarded. Premium is measured by underwriter, loss ratio and development is not.



## Correcting the Decision-Making Process

- **Effective price monitoring has to occur at the same location as effective underwriting; the underwriter's desk.**
- **Price monitoring needs to become a real part of the evaluation process for rating agencies and analyst. (Remember the grading chart).**
- **Senior Management and analyst emphasis on top line premium growth and expense control is often at odds with effective price monitoring.**



## Conclusion

### Revisiting the framework from our introduction...

#### 1. **Communicating the Territory:** Goals – Acting Congruently

Say: What is the goal? What do we really want? If we achieve that what will it mean?

Do: What is the risk manage along the way to ensure we act congruently with the goal?

#### 2. **Facilitating Interactions: Possibilities** – Best Fit for Purpose

What are the possibilities? How do we evaluate and identify most fit-for-purpose possibility?

#### 3. **Producing Outcomes:** Measure – Adapt

What are the lead indicators that will measure/mark performance?

How will we achieve a ‘speed to adapt’ (homing) and be resilient rather than perfect?



## Contact

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