Performance-Focused Risk Management: Tying It All Together

By Carol Williams

Over the last three issues of The Demotech Difference, we have discussed the building blocks of an enterprise risk management (ERM) process focused on ensuring a company's success: 1) developing the right mindset and culture, 2) identifying the unique needs of the company, and 3) developing processes and tools based on these needs for the company at-large.

All companies, especially P&C insurers, conduct risk management in one way or another — whether it is through product development, pricing, underwriting or handling claims. This has traditionally involved individual business areas identifying and managing threats to their specific business goals and operations.

Contrary to what the term implies, risk management is not just about preventing losses, but rather about understanding the interrelation between risks, how they impact strategic objectives, and incorporating this knowledge into decision making in a systematic way.

But as explained in the first part of this series, taking an ad hoc approach isolated within a particular "silo" that focuses on minimizing harm and risk taking leads to a host of issues that are frustrating for executives trying to steer their companies through turbulent waters.

The Result?

Executives and support staff are reacting to urgent crises and putting out fires instead of pursuing and achieving goals. This constant state of chaos can eventually lead to higher reinsurance rates, financial concerns, disruption by a more agile competitor, and possibly even a ratings downgrade.

Enterprise Risk Management: Only a Compliance Exercise?

Many P&C insurers stumble into enterprise risk management (ERM) because they have met thresholds set forth in their state's Own Risk & Solvency Assessment (ORSA) regulations, or the company is publicly traded and therefore must report top risks to the SEC. However, when a company implements ERM due to a regulatory requirement, it becomes another check-the-box activity in the eyes of executives and not a valuable tool for helping the company succeed.

Contrary to what the term implies, risk management is not just about preventing losses, but rather about understanding the interrelation between risks, how they impact strategic objectives, and incorporating this knowledge into decision making in a systematic way. ERM should provide tools for both executives and the company at large to understand which risks are acceptable to take, which risks are not acceptable, and which risks need to be addressed through mitigation and other means.

At the executive level, the ultimate goal of a fully integrated ERM process isn't to manage every risk (… which would be impractical and impossible), but rather to understand risks around strategic goals and then use this information to guide decisions on the company's direction.

ERM and Its Role in Decision Making

It's no secret that P&C insurers have been facing many hurdles over the last 18 months and counting.

Whether it's escalating claim volumes caused by stronger, more frequent weather events, widespread dubious litigation, negative financial results, threats of rating downgrades, increasing reinsurance costs, or more regulatory scrutiny (the list could go on and on), the P&C industry has never faced such monumental challenges. These threats, coupled with seismic changes around the world, could prove fatal to companies not equipped to deal with them.

One source of these challenges for some companies is the continued use of operational and decision-making processes that the company has outgrown or have become outdated. The same thought process also applies to risk

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— the company's approach towards risk needs to be continually evaluated for effectiveness and appropriateness.

Part 3 of my series in the Fall 2020 issue discussed the importance of developing tools and empowering personnel throughout all levels of the enterprise to use these tools in the decision-making process. But if executives are not using the same risk tools developed for the company at large to chart its future, the whole ERM house of cards will ultimately fall and the company will be at much higher risk of acquisition or liquidation.

Many executives tend to focus exclusively on their silos without thinking holistically about the company. While quite versed in their area of expertise, they often remain timid when it comes to asking questions or challenging assumptions about ideas from other areas. For example, Claims has their list of projects while Underwriting has theirs, but the two never meet to coordinate how their respective efforts will help the company achieve its objectives, not to mention discussing any cross-functional risks introduced by one area's activities.

Now this may seem like reason enough for executives to ask questions and challenge assumptions about the ideas and initiatives of other areas of the company, but there's another big reason — cognitive bias.

The phenomena of cognitive bias can be devastating to a company and therefore makes a robust culture of asking questions and challenging assumptions of other areas, even ones you are not familiar with, all the more important.

Some examples of cognitive bias include prejudice for or against a particular person's ideas, a tendency to see things the way you want them to be instead of the way they are, and trusting your memory or gut rather than objective data.

There are many sources of this bias that everyone, including the CEO and other executives, must always be on guard for. The phenomena of cognitive bias can be devastating to a company and therefore makes a robust culture of asking questions and challenging assumptions of other areas, even ones you are not familiar with, all the more important.

Besides, experts are typically over-confident and want to paint a rosy picture. According to Douglas Hubbard in his book "The Failure of Risk Management: Why It's Broken and How to Fix it":

"… researchers have been showing that if we ask people for the chance that some prediction they made will come true, they will systematically apply too high a probability of being correct. In short, they are not as correct as often as they expect to be."

A Painted Picture of Strategic Conversations

Picture this. You have executives sitting around a room (or in this COVID-19 world, as little squares on your computer monitor for a Zoom or Teams call). Instead of hearing an idea from a colleague and responding, "That sounds like a great idea. Let's do it," peers are asking questions about the goal of the initiative, challenges, solutions, and the level of risk the company is willing to take. Robust, congenial but challenging conversations ensue, negating some or most of the cognitive bias or over-confidence among subject matter experts and fellow executives.

So how do you know what questions you should be asking? Here are a few general and industry-specific questions you can be asking of your peers in strategy development and decision-making:

- What would have to be in place for this goal or initiative to be a success?
- What could get in the way of achieving this goal or initiative?
- What will be our criteria for success?
- How much time and financial resources will it take to meet these criteria?
- What are the opportunity costs of this course of action?

- Are there any other carriers doing this? What has their experience been?

- Are there any regulator constraints or considerations that need to be incorporated?

- How will our policyholders (or other relevant stakeholders) react to this change?

- Will our investors be comfortable with this particular course of action?

This is just a small sampling of questions. Every company and even individual circumstances will warrant specific questioning to ensure the goal, initiative, or solution meets the needs of the company and aligns with the desired level of risk taking without introducing new unacceptable risks.

Over their entire careers, executives have been making decisions and weighing the pros and cons of those decisions. However, it must be done in a systematic, disciplined way, and involve all relevant parties.

By laying a solid foundation through developing a risk-aware culture, identifying the company's unique needs, and enabling and empowering personnel to ask questions and challenge assumptions, ERM can be a powerful tool for managing the company for success in an ever-turbulent world.

One thing is clear — all you have to do is read the news and speak with peers to understand that turbulence and uncertainty are becoming more intense year after year. For companies to remain relevant and thrive, executives will need to re-think strategic planning and decision making to ensure the path(s) the company chooses are truly risk-informed.

Are you ready to seize the day and begin charting your company's future course?

Carol's career in insurance and risk management spans almost two decades, during which she has held a variety of positions as a Florida insurance regulator and industry expert. With over 10 years of hands-on experience in the ERM profession, Carol works with her clients to build sustainable ERM practices to support decision-making and strategic planning. Learn more at www.StrategicDecisionSolutions.com or email Carol@strategicdecisionsolutions.com.