Insurers relish the chance to take a second bite at risk appetite

Refined palates crave more value

By Jason Abril, Mark Mennemeyer and Alkis Tsimaratos

Jason Abril
is a director specializing in enterprise risk management.
Willis Towers Watson, San Francisco

Mark Mennemeyer
is a director specializing in enterprise risk management.
Willis Towers Watson, New York

Alkis Tsimaratos
is managing director, head of Willis Re's West and South EMEA region.
Willis Re, London

It's becoming rare these days for insurers not to have a defined risk appetite framework. The Willis Towers Watson 2017/2018 Global Reinsurance and Risk Appetite Survey* highlights this, with 76% of insurers reporting that they have adopted a formal risk appetite statement, a 12-percentage-point increase from 2015 (see regional breakdown in *Figure 1,* next page). Moreover, 99% of respondents expect to have a statement in place by 2020.

A history of lack of perceived value

Yet for all the activity in this area, senior management and company boards have often been left exasperated. A common complaint we've heard of late from insurance company board members is that enterprise risk management (ERM) programs' risk appetite statements are historically too far removed from day-to-day business realities.

Ninety-nine percent of respondents expect to have a risk appetite statement in place by 2020.

The substantial strides that insurers have made to define risk appetite frameworks in recent years haven't always resulted in obvious business value – at least not from a board perspective. Many are taking steps to correct this.

A sampling of their frustrations include:

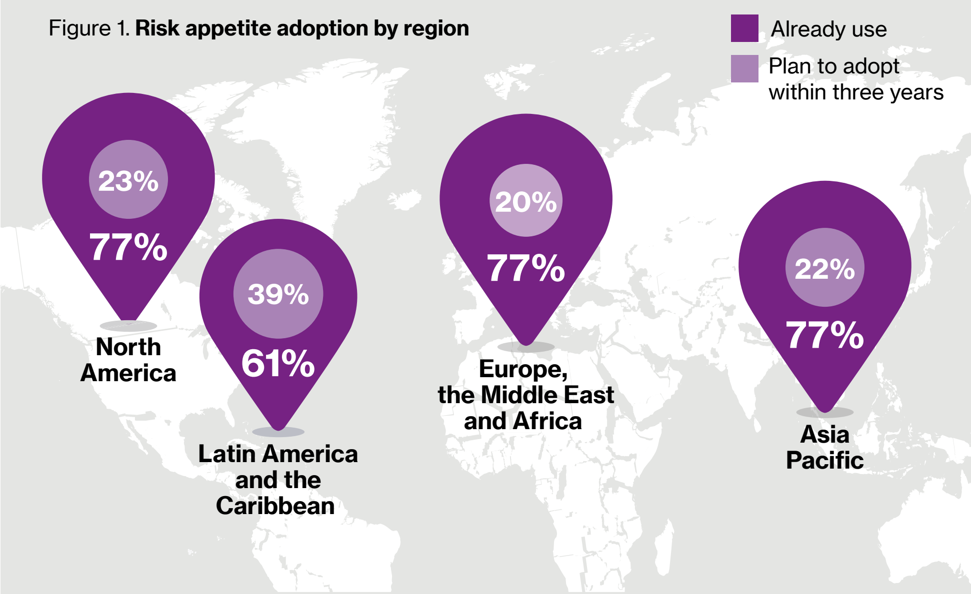
- Where's the value in defining risk appetite? It doesn't help us generate income.
- The return on investment and management time is hard to justify.
- We've got a statement, but it's not actionable for connecting risk tolerances to operational risk limits; it has no teeth.
- Monitoring systems aren't timely enough.
- It doesn't help our employees decide what risks they can or should take.

The source of those frustrations often emanates from the initial motivation to define risk appetite. Arguably, the source is often external regulatory or rating agency requirements rather than broader internal business objectives. This tick-box exercise overemphasizes solvency risk above other business risks, with little thought for business implications.

The often tenuous links between the resulting risk appetite statements and business decisions are exposed when senior leaders are unable to demonstrate linkages between policy and business practice. In these cases, the risk appetite statement is perceived as a creation emanating from the risk function, rather than a business-wide philosophy that is broadly enforceable across the organization.

*https://www.willistowerswatson.com/riskappetite2018

Figure 1. **Risk appetite adoption by region**



Source: Willis Towers Watson 2017/2018 Global Reinsurance and Risk Appetite Survey

Redressing the imbalance

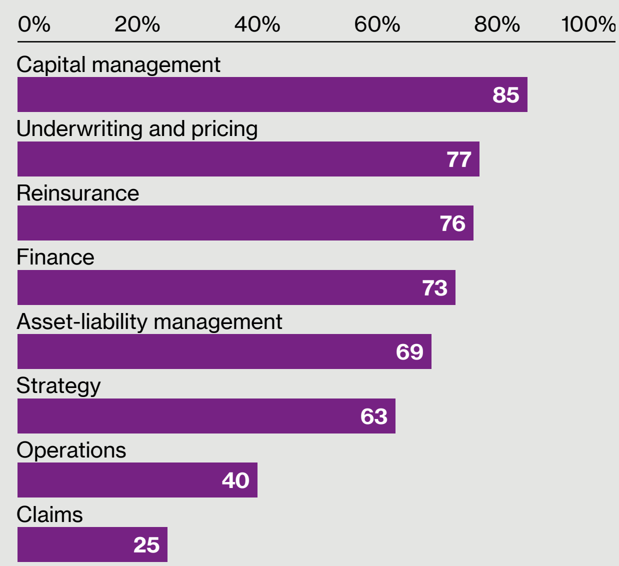
The risk appetite challenge then is to realize business value from statements while also satisfying regulatory and rating agency obligations. And the core issue is linkage.

In essence, the risk appetite statement aggregates a company's qualitative and quantitative approaches to risk. By definition, it's high level. But to effectively monitor it, provide and set risk tolerances and, critically, link operational risk limits for frontline employees, companies need a detailed understanding and quantification of risks. They also need to communicate that information to the people who need it, when they need it and in a way they can understand. Some companies, in their enthusiasm to satisfy regulators and rating agencies, might wish they had approached the task differently.

It's interesting to note that there's a move to monitor risk appetite reviews more regularly. This is particularly true for smaller companies (less than $100 million gross written premium), where 38% say they are reviewing risk appetite on either a monthly or quarterly basis. While larger companies suggest they also have ambitions of this sort, more stringent regulatory processes continue to make it difficult for them to escape an annual review cycle.

We find that many companies are ramping up their efforts to generate specific business benefits. Among the business areas where risk appetite is playing a larger part *(Figure 2),* the role of reinsurance in achieving capital management and earnings protection is attracting particular attention. Over half of companies report that earning protection is now their main driver for evaluating reinsurance strategies.

Figure 2. **Department(s) using your company's risk appetite framework**



Source: Willis Towers Watson 2017/2018 Global Reinsurance and Risk Appetite Survey

A common board complaint: ERM programs' risk appetite statements are historically too far removed from day-to-day business realities.

Modeling advances and structured solutions

Eighty percent of insurers surveyed now consider their risk appetite statements when optimizing their reinsurance strategies. In this respect, improvements in modeling capacity and techniques have undoubtedly helped. Faster processing speeds, the widespread availability of cloud computing, and such modeling techniques as proxy functions and clustering have come together in a way that enables insurers to analyze portfolios at more granular levels. This granularity helps them identify how each portfolio responds to specific risk drivers, how these drivers contribute to the capital requirement and earnings volatility in aggregate, and where reinsurance fits into that. Most insurers in our survey are considering broader and more complex earning metrics as a result.

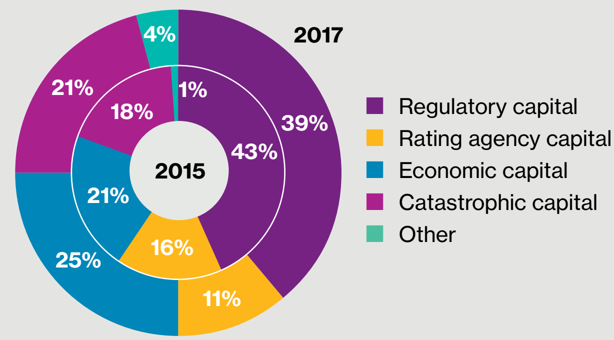
With these more comprehensive risk metrics available to quantify different areas of risk to the business, reinsurance buyers are looking to a wider range of cost-efficient and flexible risk management structures such as adverse development covers, swaps and structured quota shares. Around a quarter of companies, and a higher proportion of larger insurers, say they have purchased structured reinsurance solutions as a result.

Higher levels of modeling sophistication are also reflected in the measures that companies use to monitor capital. Tellingly, 52% of companies are now using internal capital models – up from 33% in 2015. Although regulatory capital is still the most relevant capital measure *(Figure 3),* economic capital and, among P&C insurers, catastrophe risk capital are gaining momentum.

A refined palate

There's little doubt that insurers appreciate the benefits of formally defining risk appetite. But work is taking place to refine the palates of boards looking to redress the balance between risk appetite frameworks that serve regulatory purposes and business value creation.

Figure 3. **Capital measures most important to the reinsurance decision**



Note: Solvency II and equivalent countries include: Bermuda (full equivalence), EU and Switzerland; Australia, Brazil, Canada, Japan, Mexico (provisional equivalence) and U.S. as of Commision Delegated Decision (EU) 2015/2290

Source: Willis Towers Watson 2017/2018 Global Reinsurance and Risk Appetite Survey

Eighty percent of insurers surveyed now consider their risk appetite statements when optimizing their reinsurance strategies.

For comments or questions, call or email Jason Abril at +1 415 871 1630, jason.abril@willistowerswatson.com; Mark Mennemeyer at +1 212 309 3959, mark.mennemeyer@willistowerswatson.com; or Alkis Tsimaratos at +44 20 3124 8694 alkis.tsimaratos@willistowerswatson.com.