Enterprise Risk Management Loss Reserve Risk Strategy and Plan B

Casualty Loss Reserve Seminar
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Initial Thoughts

- Strategic Planning at the CLRS ??
  - Oxymoron or Step into a new frontier

- Can reserving be strategic ??
  - Conventional wisdom suggest this thinking gets you into trouble!
    - NOT about strategically setting the reserve
  - Process of understanding the drivers of your reserves can make you a strategic partner in your company.
  - Think portfolio theory and risk levels
    - Avoid too much focus on individual cells
- Transforming from 20th century actuary to 21st century actuary

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Agenda

- Background
  - Why reserves
- ERM Process
  - Silos and Integrated Approach
  - Advanced Steps
    - Correlation analyses
- Focus on Reserves
  - Reserving actuary
- Communication
  - Management, External Parties, Board
- Other strategic thoughts

Background

- Why Reserves within ERM ?
  - Management's best estimate, disclosure requirements, statement of opinion, Sarbanes Oxley, heightened auditing processes, and greater board visibility potentially mitigate concerns over reserve adequacy
  - natural catastrophe events, pricing risk perhaps more volatile
  - Stochastic reserving, modeling techniques, and discussion on ranges
  - hard market typically coincides with reserve redundancies

- Reserves remain the largest risk on a company's balance sheet
  - Large percentage of recorded liabilities
  - Subject to much historical volatility (fairly or unfairly)
  - Need to focus on drivers of variability

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Background - Continued

- Volatility for many reasons
  - Inability to identify changing trends
    - Propensity to sue, Judicial reforms, medical inflation, attitudes of jurors
  - Reinsurance issues
    - Inadequate amount, misunderstanding of coverage, potential for dispute
  - Misestimating where we were in the pricing cycle
    - Primary rate change, tort costs, focus on production vs. underwriting
  - Shocks to the System
    - Legislative reforms, asbestos and pollution, aggregation of exposures
- Focus on lessons learned
  - Appreciate the possibility for history to repeat itself
  - Beyond traditional methods and analyses

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Process

- Traditional Approach to Reserving
  - Adequacy, profitability, changes from prior
- ERM – Initial Phase
  - Silo approach – focus on categories
    - Identification
    - Measurement
    - Management
  - Communication by individual risk owners
  - Need to incorporate claims adjusting process
- ERM – Second Phase
  - Bringing it all together
    - Holistic approach / Connecting the silos

Process

- ERM Process – Third phase
  - Correlation Analyses
    - Need to reflect interactions with other stakeholders
    - Enron effect
  - Examples
    - casualty policies, professional exposures, assets
    - Catastrophe events on property coverages, investments in cat bonds, mortgage backed securities
    - Sub-prime lenders, E&O policies, financial institutions
    - Homebuilders policies, surety coverages, interest rates
    - Pricing errors and impacts on loss reserves
- Adding value by understanding other parts of business
  - Understanding and communicating

ERM - Focus on Reserves

- Traditional process
  - More than adequacy, profitability
  - Feedback mechanism on underwriting process and claims adjusting
  - Strong opportunity to communicate results to management and focus on drivers of results and potential favorable / adverse events
- Drivers of Reserves - Identification
  - Adverse claims trends
  - Leading indicators
    - Claim frequency, large loss notices, industry information, ceded issues
  - Hyper correlation of exposures
  - Large policy limits in targeted sectors
  - Poor underwriting strategy / Inadequate handle on pricing

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Focus on Reserves - Continued

- Drivers of Reserves -Measurement
  - Modeling the variability
    - Outside vendor models, in-house tools, what if analyses
    - Build in correlations
    - Understand likelihood of these results
      - Communicate to management
      - Build a plan around these events
        - Capital raising, reinsurance transaction
    - Dive into the underlying causes
      - Causality versus correlation
  - Management of these drivers
    - Proactive to mitigate future risks

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Communication

- Consider the Audiences
  - Management
    - Executive team, Reserve committee, Risk committee
  - Board of Directors (Audit or Underwriting Committee)
    - Sarbanes Oxley, put reserve risk in context with other risks
  - External (The Street, Rating Agencies, Regulators)
    - Caution on how the message is perceived
- Consider the Message
  - Move away from the point estimate
    - Embrace the range, communicate the volatility
    - Don’t be Pollyanna
  - Communication of drivers allows management to make better decisions
    - Consider risks in the reserves when making investment decisions

Strategic Planning

- Three approaches
  - Contingency planning
    - What we will do if/when this happens
      - Need to model both
  - Sensitivity analysis
    - Focus on cause and effect – the drivers
  - Scenario analysis
    - More than simulation
      - Present different paths under different assumptions
    - Look at the external factors as well as internal
      - Litigation environment, medical inflation, demand surge, point in cycle
- Portfolio Theory
  - Reserves is one part of the entire group of risks in portfolio

Concluding Thought (to summarize)

- Know the underlying exposures and drivers;
- Create dashboard showing variability
- Test the results (scenario analysis)
- Communicate scenarios
  - Drivers and likelihoods,
  - Avoid Pollyanna
- Think about entire portfolio
- Welcome to the new frontier