Institutionalisation of Risk Management in Life Insurance

One of the major concerns of regulators, management and customers in the life insurance industry is the efficiency in management of risk, particularly in view of the long-term nature of asset/liability management. The rapid changes around the world of late have made it difficult for information systems and management practices to capture fully the potential trend and direction of uncertainty, which results in an adverse impact on enterprise-level performance. In this article, **Dr H Sadhak,** the Chief Executive Officer of LIC Pension Fund Ltd, urges companies to recognise the emerging risks in the industry and institutionalise risk management practices separately from operational functions.

The life insurance industry has been confronted with changes in the area of demographic profile and longevity, convergence in financial services industry, changing product market relationship, unpredictable volatility in financial markets, emergence of complex new products, changes in computer technology and information system, discovery of new types of killer diseases, as well as structural changes.

While globalisation has dismantled the barriers of local markets and extended the scope for market expansion, it has also increased the uncertainty and multidimensional risks in management of liability. Globalisation has also opened the links to transmit the global fallout to unsophisticated vulnerable local markets, making the standard risk management matrix often incompetent to tackle risks. Never before has the life insurance industry been exposed to so much market and enterprise-level vulnerability, and unless insurers pay serious attention to risk management, an unexpected tsunami may wash away the gains so far achieved by many life insurers.

In reality we observe that there is a mad race for market share, which often leads to the launch of risky products, unscientific product pricing creating a disequilibrium in embedded value and cost, which serve neither the long-term interest of the consumers nor the company. Life insurers, particularly in the emerging markets, need to focus on this issue for their long-term growth and survival.

Sources of Risks

Risks management in a life insurance operation is a complex problem since it arises from various known and unknown sources like macroeconomic changes, pricing, claims, credit spreads and investment market volatility, mortality/longevity assessment, future guarantee, inadequacy in reserve/ solvency margins. The major known risks experienced by life insurers are mentioned below:

- ***Underwriting Risks***

Arising from inappropriate assessment of financial and mortality risks of a policy, potential claims due to poor quality of underwriting knowledge and process.

- ***Actuarial Risks***

Associated with issuance of insurance policies and related liabilities. These risks arise due to higher cost of raising funds and higher underwriting losses than projected.

- ***Pricing Risks***

Arising from uncertainty in mortality, claims, management expenses and income from premium, investment and real estate.

- ***Asset – Liability Risks***

Arising from mismatch between assets and liability of an insurance company due to fluctuation in interest rates, inflation causing changes in value of assets and liabilities. It also arises from the default of borrowers causing a decline in market value of investment assets.

- ***Systemic or Market Risks***

Arising out of changes in assets and liability due to systemic changes in market factors. Systemic risks may be hedged but cannot be diversified fully. The important market or systemic risks are: Interest rate risks, equity and property risks, credit risks, liquidity risks and asset-liability management risks.

Risk Management Techniques

Several techniques have been designed for measuring and managing risks that are basically directed towards understanding and matching liability and assets of an insurance company. These techniques can be broadly indicated as: Portfolio segmentation; cash flow management (CFM); cash flow testing (CFT); solvency testing; optimisation analysis; gap analysis – duration and convexity testing; hedging; risk-based capital ratios; actual and expected experience monitoring (A/E Ratio); stress testing; liquidity analysis; scenario analysis. However, these techniques are mostly related to asset liability management and dynamic financial analysis that are tools of strategic management support. There are other risk measurement techniques which focus on valuation, capital adequacy and performance measurement.

Valuation methods are used to analyse economic value, appraisal value, profit testing, market value margin and fair value methods. Capital adequacy methods are used to measure statutory solvency margin and reserve requirements, risk-based capital and value at risk – mostly regulatory requirements.

Risk Management Strategy

A new approach which is gaining prominence for risk management and development of strategy is called risk budgeting (RB). It is a disciplined and structured risk management approach. In RB Strategy, goals are established through risk allocation and performance continuously measured against the budget. During recent years a new concept is gaining momentum and is called enterprise risk management (ERM) which is an extension of financial risk management (FRM). ERM focuses on non-financial contingencies in addition to financial factors. ERM is a broader concept and takes into account factors like human resources, distribution channels, corporate governance and technology.

Institutionalisation of Risk Management

Risk management is a philosophy that needs to be universally accepted by the individual employee as well as the management of the company. However, this philosophy cannot be imposed and will not work if thrust upon them through only control mechanism. Companies will have to promote a culture of risk management. Individuals in the organisation must own this philosophy in such a way that they become the owner of risk management. Any avoidance will create leakages, thus making risk management system defective. For effective institutionalisation of risk management practices and creating risk management ownership, an organisation must relentlessly make the effort to create a corporate culture of risk management and put in place a system of corporate governance.

Corporate Governance and Risk Management

Corporate governance plays a crucial role in promoting transparency in management of a corporate and thus creates a culture of disclosure, vigilance, accountability and sensitivity about risk management among managers and other employees. Since corporate governance also promotes strategic vision of the organisation it also strengthens the organisations' risk management strategy. Procedures should be in place to inform board members about the risk assessment and minimisation procedures. These procedures should be periodically reviewed to ensure that the executive management controls risk through means of a properly defined framework.

Management should place a report before the entire Board of Directors every quarter documenting the business risks faced by the company and measures taken to address and minimise such risks, and any limitations to the risk-taking capacity of the company. The board should formally approve this document.

Vision and concern of the board members exhibits sensitivity of the top management about risk management and necessary internal control and supervision. Concern of the board will also be reflected in developing, implementing and monitoring a risk management mechanism as well as fixing individual responsibility. Therefore, the board needs to initiate such practice which, in addition to the regulatory requirements, will incorporate voluntary initiatives with a long-term perspective of risk governance. The corporate governance standard on investments and comprehensive risk management format needs to be adopted with a view to clearly separating the duties, decision-making and co-operation between the Board of Directors, CEO and other Executives.

Corporate risk management mechanism calls for a well-meaning, long-term policy in the light of corporate vision, mission, goal and various stakeholders' interest. These policies need to be effectively supported by well-designed procedures. No doubt, controls are required and are an essential component of risk policy. Internal control, however, needs to be seen as instruments for empowering people and providing them with guidelines to control activities to mitigate various risks.

Internal control has many elements, which is influenced by the vision of the company and alertness and desire of the Board of Directors, management and other personnel. The board should ensure the effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations. The board and management must ensure effective internal control based on sound procedures and ensure risk management through active participation of people at various levels.

Risk Standard

Insurance regulators and insurance associations have an important role to play to introduce and to ensure that risk management becomes the norm in the industry. Therefore, a uniform risk standard needs to be introduced through the life insurance industry which may be called the Life Insurance Risk Standard (LIRS) incorporating risk identification, measurement and management and oversight.

Conclusion

Institutionalisation of risk management practices calls for separating risk monitoring (RM) from the operational function. Monitoring should be entrusted to the entity not involved in operational matters. Though implementation will be reviewed by the primary fiduciary-like board, top management, yet there is necessity for independent monitoring through a designated person. Many organisations appoint a Chief Risk Officer (CRO) for this purpose who is a reasonably senior-level executive reporting to the CEO/board.

The CRO functions independently and submits periodic report to the CEO either quarterly or on a half-yearly basis. However, the success of CRO system depends largely on the independence of the CRO, and this will depend on the commitment of the top management within a well-designed format of risk governance. Risk governance can be established either through "risk control" or through "risk reward". In either of these models there is a necessity of improving risk knowledge, risk information and competitive risk practices. Genuine risk reporting and the starting of risk information will strengthen risk governance. Risk management has its costs, too, but management must think in terms of long-term benefits and be willing to bear the costs in the long-term interest of the company.