ERM in the Middle East
Moving beyond compliance

Messrs **Safder Jaffer** and **Mark Stephens** of **Milliman** discuss how companies can move beyond box-ticking and derive greater value from their enterprise risk management (ERM) initiatives.

ERM is still in the development phase in the GCC markets. Insurers are increasingly sensing the need to have more robust and systematic risk management processes for the future, largely to meet either regulatory or rating agency requirements.

However, many GCC insurers still view ERM as just a compliance exercise or a rating agency requirement, failing to recognise that their ERM programmes are also meant to generate significant business value. With only a few companies in the region beginning to move beyond compliance and pursue greater value from their ERM initiatives, companies with a mature approach to risk management can achieve a competitive advantage.

When ERM is not embedded

Many companies in the Middle East, as of late, hire consultants who set up the standard risk registers, providing the ERM platforms. Management typically feels contented when this is put in place. The reality is that rating agencies are barely impressed by such initiatives that appear fancy on paper but are missing the soul (which is the objective of having an ERM in the first place).

ERM is thus not embedded to generate significant business value. Many programmes lack the key functions of ERM such as defining a clear risk appetite, risk tolerance, or well-defined risk limits. They should monitor risks on a frequent basis with updates that allow corrective action, and implement either escalation processes or capital models with the ability to evaluate risks. Moreover, approaches are quite often backward looking (ie, they are based on the analysis of losses/effects produced by risks in the past) and this implies that they are unable to identify and manage risks which have never produced effects in the past.

Foundational approach to ERM

A foundational approach to ERM would include a periodic risk assessment process across all risk categories, a systematic method to understand controls and mitigation efforts, some way of relating exposure levels to risk appetite and capital levels, and the communication of business insights resulting from these processes. Because the successful execution of ERM is not well-understood, it is challenging for most executives to prioritise the resources necessary to support a value-driven ERM process. Even a foundational or beginning ERM process should not consume significant resources, nor should it be complex to execute or time-consuming.

Value-driven ERM process

Successful ERM programmes should be driven by the following value drivers:

- Integration into performance management and reduction of performance volatility;
- Capital efficiency;
- Active stakeholder management; and
- Operational excellence.

Integration into performance management

ERM should help a company understand potential variation from goals and objectives. Most organisations are driven by a series of financial and operational metrics and they are the assumptions in financial planning. Achieving these objectives supports dividends, capital allocation, and incentives. Therefore, understanding vulnerabilities or high-risk exposures is critical in prioritising limited control and mitigation capital.

A proactive and efficient ERM approach can even provide business or strategic advantages. For example, a proactive management of the rough materials costs volatility could help companies to support commercial campaign(s) with discounts which reflect the change in rough material costs.

Capital efficiency

ERM can support higher capital efficiency through a risk-adjusted return on capital (RAROC) analysis. High-quality, risk-adjusted financial planning is growing rapidly and there are many benefits derived that can result in a more effective capital allocation process. The ERM process should inform the financial planning process and there should be a resulting reconciliation of risk exposures between the two processes. More collaboration, communication, and data sharing are essential to this activity.

Active stakeholder management

Active stakeholder management is essential to keeping partners well-informed and confident that risks are understood in a rapidly changing environment. Whether it is the board of directors, shareholders, employees, regulators, rating agencies, reinsurance companies, policyholders, or distribution partners, they all need to be confident that an organisation is managing its risks.

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Operational excellence

The final element of the ERM value proposition is the support it provides to any quality control process. Quality control can be in the form of six sigma teams, internal audit or departmental quality teams, but they all examine some performance to expected standards. ERM can help understand acceptable variation from those standards and also periodic validation of the same standards. For example, policyholder retention or underwriting submission acceptance rates may be under target and also have a significant impact on profitability. A remediation plan for one of these challenges may have a very high return on investment.

ERM case study

Recently, a mid-size UAE insurance company designed, tested, and implemented an ERM process that included all senior executives and department managers in the process. Analysis and insights from the process were presented to a rating agency along with a submission for a rating renewal. The CFO was convinced that the ERM results were an important part of final rating improvements.

The company managed to define its risk appetite, including both the qualitative and quantitative measures, for its board and management. ERM has now become an integral part of the organisation's day-to-day business and fully integrated with its business plan and future growth in the market.

Execution of ERM process

This four-part value proposition is predicated on an ERM process that is low-fatigue and high-value to the organisation. The execution of the process should require minimal resources and cannot be redundant to existing requirements. Therefore, the design and testing of the process should involve key executives who can share strong opinions about how the process is executed while maintaining the integrity of what needs to be accomplished. This will provide for the necessary executive vetting and consensus building that has to be a part of building any ERM process.

Finally, the ERM process must support capital adequacy ratios and solvency margin calculations and requirements. The well-known industry risks of underwriting, investment performance, reserving, capital performance, and liquidity usually get the most of the risk assessment effort. Similar resources should also be devoted to many operational and strategic risks that can also affect operational and capital performance. M

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