Enterprise Risk Management & Captives

Enterprise risk management may be nothing new but it could prove to be a bright light for captives in the gloom caused by global economic recession.

What's this enterprise risk management (ERM) all about then? It's certainly not new; the risk management community has been using ERM methodologies for years, so why all the excitement?

Very briefly, ERM is the latest wrap-around term to describe a top-down, dynamic and holistic risk management framework or process. It's the natural evolution of other frameworks from around the world and is a further raising of the risk management bar. There are many definitions of ERM, but the shortest and most succinct that I've found is "the methodical management of all material risks."

Another definition which is probably easier to relate to is that "ERM is the process of planning, organizing, leading, and controlling the activities of an organization in order to minimize the negative effects of risk on that organization's capital and earnings." ERM expands the older processes to include not just risks associated with accidental losses, but also financial, strategic, operational, and other risks.

Evolving Risks

The current financial crisis has made everybody far more risk adverse, and highlighted the importance of ERM, which explains why it's now a standard agenda item of all organizations.

As businesses have become more complex over the ages, so too have the number and nature of risks in which those businesses are involved. Remember when banking used to mean borrowing and lending money? Things have moved on enormously over the past twenty years, and risk management associations world wide have constantly been widening and redefining their terms of risk reference to try to keep up to date. Furthermore, in recent years, external factors have fueled a heightened interest by organizations to clearly demonstrate that they know what they are doing, understand the risks inherent to their business and know how best to manage and control them.

Industry and government regulatory bodies, as well as investors, have begun to scrutinize companies' risk-management policies and procedures. In an increasing number of industries, boards of directors are required to take direct responsibility on the adequacy of risk-management processes in the organizations they administer. The answer to meeting all these demands is for organizations to adopt and implement full ERM programs.

The US Committee of Sponsoring Organizations of Treadway Commission (COSO) divides the ERM process into eight components:

1. Internal Environment
2. Objective Setting
3. Event Identification
4. Risk Assessment
5. Risk Response
6. Control Activities
7. Information and Communication
8. Monitoring

An important element of ERM is that although it is primarily a defensive process, it can also be used offensively. By identifying and proactively addressing risks and opportunities, business enterprises protect and create value for their stakeholders, including owners, employees, customers, regulators, and society overall. ERM is evolving to address the needs of various stakeholders who want to understand the broad spectrum of risks facing complex organizations to ensure they are appropriately managed. Regulators and debt-rating agencies have increased their scrutiny on the risk management processes of companies.

There is a significant need for ERM if organizations are to improve governance, risk/return, and revenue growth, as well as realize the myriad other benefits. Standard & Poor's (S&P) has reinforced this importance with its initiative to assess non-financial firms on their ERM implementation in its company ratings, which began in 2009. Other rating agencies are implementing similar rating processes.

Financial institutions that thrive on the business of risk are excellent examples of companies that can benefit hugely from effective ERM. Their success depends on striking a balance between enhancing profits and managing risk.

It is a challenge to identify best practices for implementing ERM, because until recently these have been few. However, more ERM best practices are beginning to emerge. It is paramount that the board of directors drive the implementation exercise. Everyone in the organization must be responsible for managing some aspect of risk. Everybody in the organization must be involved; there can be no exceptions. All individuals must be trained in basic risk management skills, a risk framework must be adapted to the organization's needs, and risk tolerances must be set by the board. Internal auditors can help the implementation effort by learning all they can about ERM, as well as by networking with risk professionals. They also need to challenge the external auditors to get appropriate support for this initiative. Finally, internal auditors and risk managers must do more to educate their board about ERM to ensure the right outcomes.

As a result of this increased awareness of risk and the need to try to control and finance it, there exists an excellent opportunity for the insurance market to cater to these needs. In other words, 'new' risks which hadn't really been appreciated before may need to be transferred by organizations to the traditional or alternative insurance markets.

Historically, captives have thrived at times when the traditional market has not understood the underlying risks or has set its premiums too high. Examples have been in the 1950s when the large petro-chemical companies realized that insurers didn't fully understand their specialized risks and that they were bigger than the insurance companies anyway, so why not do it themselves by setting up their own captive insurance companies. Another example of when captives do well is immediately after every major catastrophe when insurers hike up their rates resulting in a hard market, and those companies with good claims experience start exploring the alternative captive options.

Good news

The conclusion is that ERM is good news for captive insurance, and captives are undoubtedly good news for risk management. When the ever-increasing number of companies that have implemented full ERM programs realise that their risk footprints have changed, they will have to reassess their current risk financing strategies. ERM is likely to identify that a company's real concerns are not fire or explosions but more 'modern' risks such as loss of reputation and cyber risk.

Captives are excellent vehicles for recovering the expenses associated with good risk management quickly and more efficiently. They also provide a stronger focus on risk prevention and mitigation techniques employed by the parent

Captives allow the owners to blend business (uninsurable) risk such as supply chain failure with standard insurable risk, establishing the facility to most effectively finance the higher variability risk costs and achieving better lower cost catastrophe protection. They also allow for leverage against the market costs when the market hardens.

Captives or self-insurance vehicles can act to show “skin in the game” and provide insurers with a stronger partnership feeling helping to gain stronger long term relationships.

Alternative market brokers, consultants, captive managers and regulators need to sit up and take notice of what's going on out there. ERM is becoming an integral part of all major organizations and is unearthing a whole host of new risks which will need to be managed. Specialist markets such as Lloyd's in London have for years been insuring those out-of-the-ordinary risks which nobody else understands or wants. So much of the expertise is out there already, it's just now time for captive consultants and managers to be more creative and to explore the many ways their captives can be utilized to insure these new risks. In addition to participating in these risks, properly structured and resourced captives can be used as the focal point for a company's ERM program, and help the directors provide a profit centre which can be used to help fund further ERM initiatives.

The silver lining of the economic crisis is that ERM will become more and more important to organizations, and the opportunities resulting from this for the alternative risk financing market, are exciting indeed.

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