

Are regulators addressing the RIGHT risk management issues?

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Putting my thoughts in context

- I think of ERM very broadly
 - Downside risk AND upside opportunity
 - ERM driver should be internal use
 - By-products for regulators and rating agencies

Research Projects

- Emerging Risks (6 annual surveys)
- Value Investing and Enterprise Risk Management: Two Sides of the Same Coin
- US Insurance Company Investment Strategies in an Economic Downturn
- ERM Practice as applied to Health Insurers, Self-Insured Plans, and Health Finance Professionals

Topics

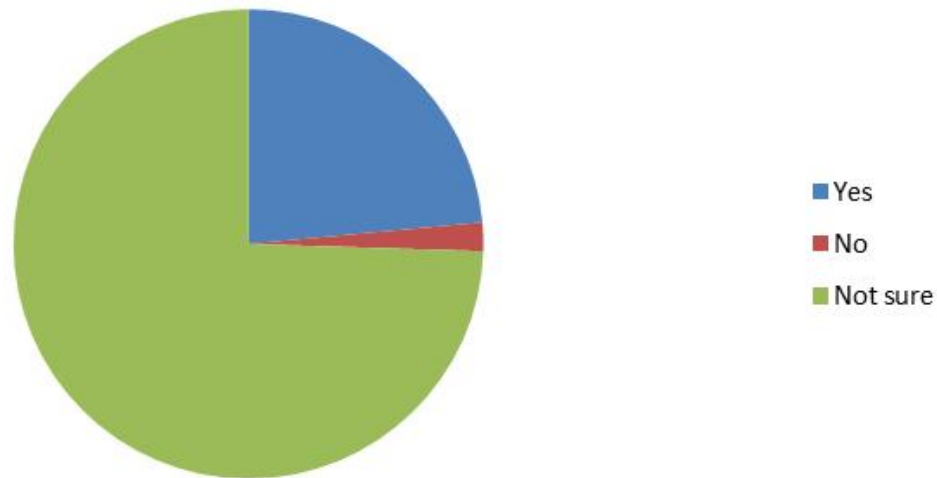
- Types of risks
- Is ERM working?
- Emerging risks
- Systemic risks
- Regulator strategies

Types of Risks

- With thanks to Donald Rumsfeld
 - Known knowns
 - Historical data available
 - Law of large numbers works
 - Statistical distributions can be used
 - Unknown unknowns (rare or new risks)
 - No data or old data
 - Exposure to outliers
 - Focus on specific stress scenarios

Does ERM improve risk profile?

Does ERM reduce risk relative to returns?



Is (internal) ERM Working? NO

- From ER survey
 1. ERM is a way for a company to "feel good"
 2. Illusion of activity without much substance
 3. ERM gives a false sense of security
 4. Analogy: reduces likelihood of fender-bender, but not likelihood of a serious collision
 5. Compliance driven

Is (internal) ERM Working? YES

1. Decision makers are engaged
2. Greater awareness of potential risks
3. Improved risk profile
4. Better risk management in the industry allows more realistic pricing
5. Best practices incorporate strategic planning

Specific uses of ERM

- 2006 low interest rates and RMBS concerns
 - Slowed fixed deferred annuity sales
 - Sold mortgage exposure
- PFG sale of home mortgage portfolio
- Watch actions of those you respect
 - Avoided FRE after Buffett sold position in 2000
- Look for concentrated exposures, interactions and herd behavior!

Emerging Risks

- Evolving risks (creeping, mean reverting)
 - Public pension guarantees
 - Home mortgage market
- Tail risk (recently unseen)
 - Earthquake/asteroid/black plague
- Correlations of risks
- Outliers, long time horizon
- Could be opportunities too

Emerging Risks

- Internal/external sources
- Higher order impact of combinations
 - e.g., oil spill/tourism
- May be positive event (e.g., nanotechnology)
- Next big risk is likely to be something new
- Are the right types of people involved to identify and prioritize?

Systemic Risks

- Actions – not companies
 - Write Credit Default Swaps
 - Originate sub-prime mortgages
- SIFI – unintended consequences
 - Gates Foundation and NGOs
 - Federal Reserve System
 - Academic institutions (efficient market theory)
- Avoid self oversight

Regulation strategies

- Basel – single regulatory methodology
 - One workaround works everywhere
- Dodd-Frank
 - Does anyone feel safer?
- NAIC – multiple regulators
 - Lowers concentration risk (don't need 50)
 - Risk Focused Examinations
 - ORSA

Role of State Regulator

- Focus on downside - solvency
- Current problems are focus
- Industry actions driving systemic risk
 - Apply to individual company
- Where will company be in 5 years
 - What risks will grow materially before the next audit?

How can states improve ERM

- Move beyond checklist exercise
- Look at risk/event interactions (e.g., ALM)
- Bring in experts who will challenge company about its future
 - Rating agencies do some of this now
 - Auditor is not the right skill set for this
- No one knows everything!

To access surveys and articles

- <http://www.soa.org/research/research-projects/risk-management/research-2012-emerging-risks-survey.aspx>

Thank you!

MAX J. RUDOLPH, FSA CFA CERA MAAA

- Rudolph Financial Consulting, LLC
 - Design/peer review ERM and ALM strategies
 - Leverage ORSA and Risk Focused Exams to add internal value
 - Continuing education and research: modules, seminars, newsletter, predictions, professionalism
 - Board level/senior management ERM sessions
- Professionalism
 - SOA Board of Governors
 - Investment Section Chair
 - Actuarial Standards Board, ERM Task Force
 - SOA President's Award



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