



Institute
and Faculty
of Actuaries

Risk: Elephants in the Room

A report on ERM conversations that haven't been happening effectively

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Purpose of the working party

- We want to talk about risks that aren't being talked about effectively.
- We want to understand what they are and why they came to be.
- We want to start a discussion on how they can become less of an issue in the future.
- This was a topic that resonated with many practitioners in the risk area.
- Our work isn't completed, so please consider this as our interim findings.

What we've done

We got together and did the following things:

- tried to list elephants;
- thought about what they had in common;
- started framing the discussion using cause, event and category;
- highlighted barriers that might cause elephants; and
- considered what might be next.

What is a risk elephant?

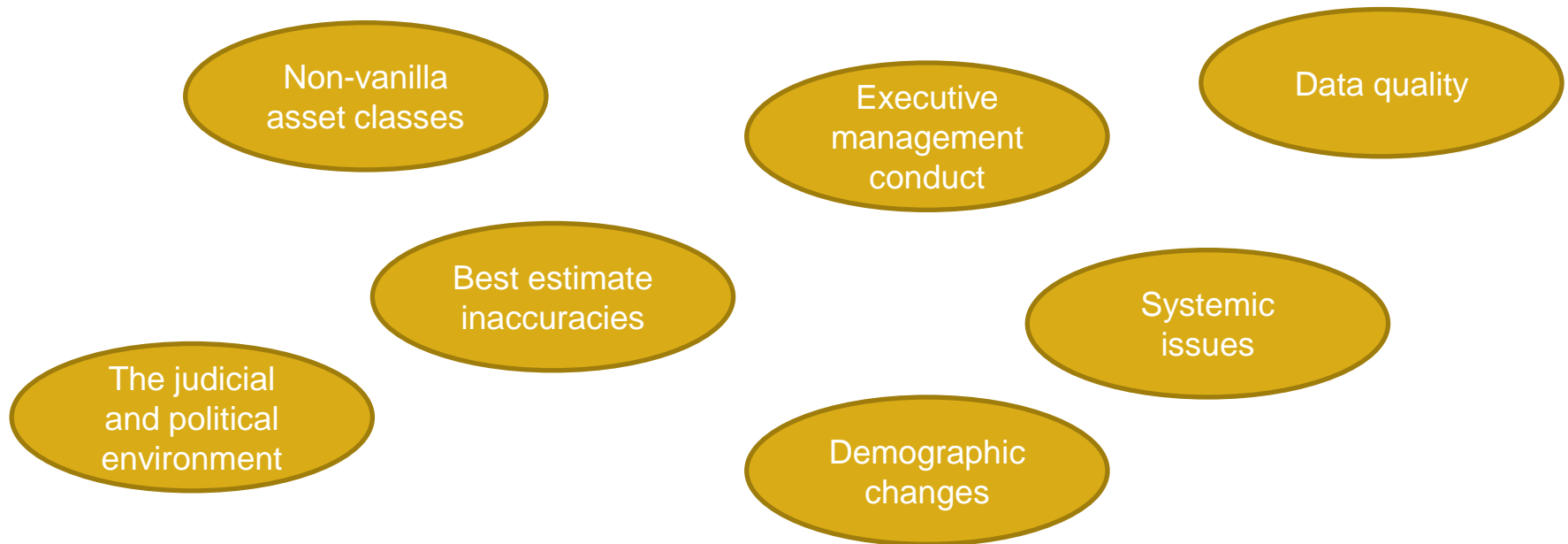
AUDIENCE EXERCISE

- Could you name some elephants?
- Is a change in UK government a risk elephant?
- Are systemic model features a risk elephant?
- Is strategic risk a risk elephant?

What is a risk elephant?

Elephants in the spotlight

- We include a more complete list of elephants in the paper but this slide has some examples.



What is a risk elephant?

- A risk is something that can go wrong. Let's consider a well understood category like insurance risk:
 - On an individual policy, it's the crystallisation of a claim.
 - On a portfolio, it's the overall book not performed as expected.
- Why did it not perform as expected?
 - If you know what you're talking about completely (like rolling an unbiased die), then there is always still a residual process risk.
 - Everything else is a type of estimation risk in that you didn't really have a handle on what you expected in the first place.
- Where is the elephant?
 - The elephant almost by definition is in the estimation error. **You didn't really understand the problem.**

What is a risk elephant?

A slide for the capital modellers...

- If you think of an estimation error as model risk (including associated parameter and process risk), you're probably not far off.
- Model risks might be an equivalent idea to risk elephants in that model risks are the things you're not aware of or thinking about properly.
 - In the extreme, if there were no risk elephants, models would only have process error.
 - In the real world, there will always be elephants and in turn model risks.
- An interesting scope question is to what extent internal models should attempt to include risks such as changes in government. In theory, they should implicitly.

Risk lineage

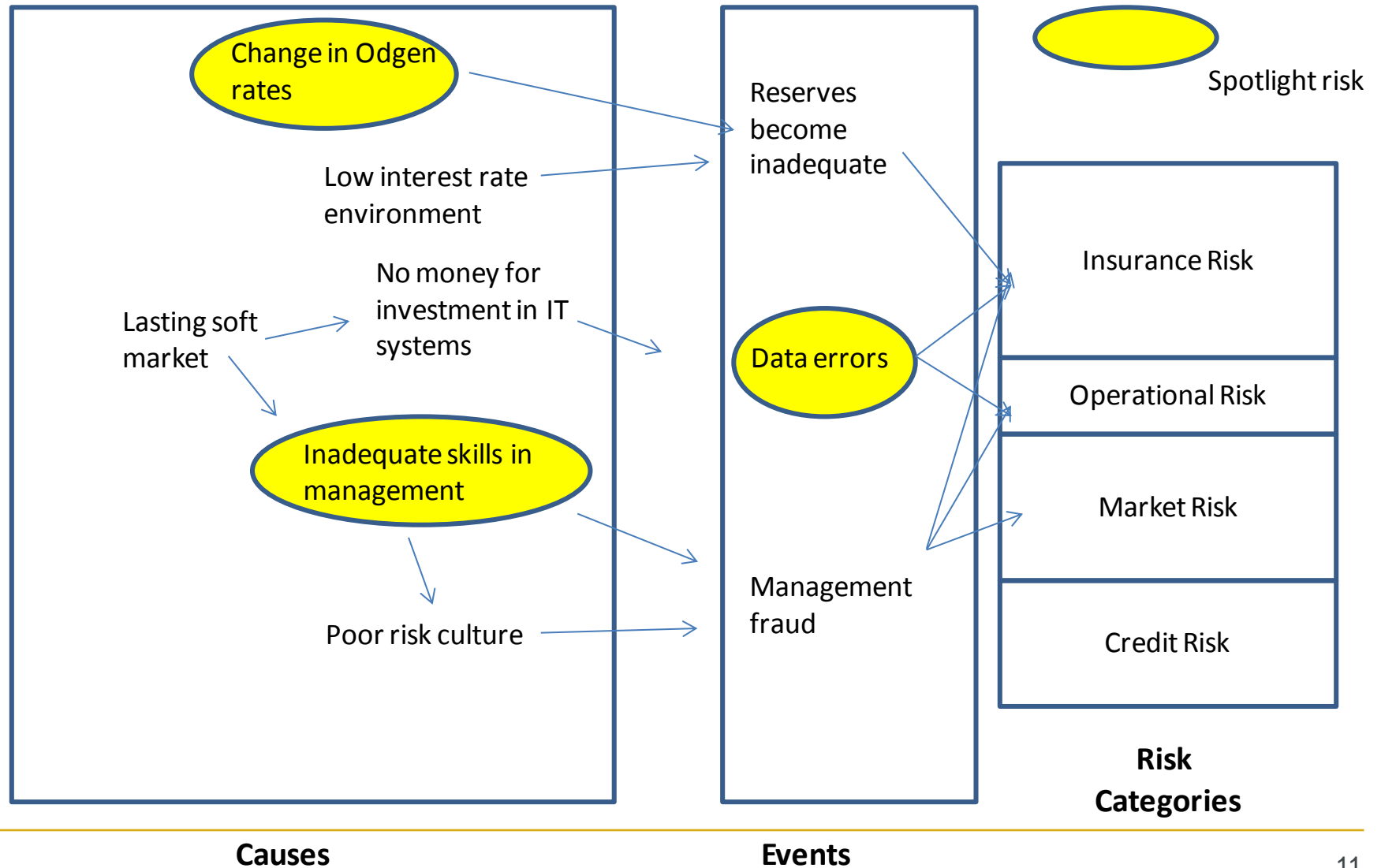
- When we started thinking about risk elephants, we thought they may be new risk categories like insurance or market risk.
- **We now feel they are uncertainties around scenarios or related causes/events which are later reported using risk categories.**
- Risk lineage may feel like a bit of a digression, but it is vital in understanding what an elephant is and then constructing a framework to discuss them properly.
- Stay with me...

Risk lineage

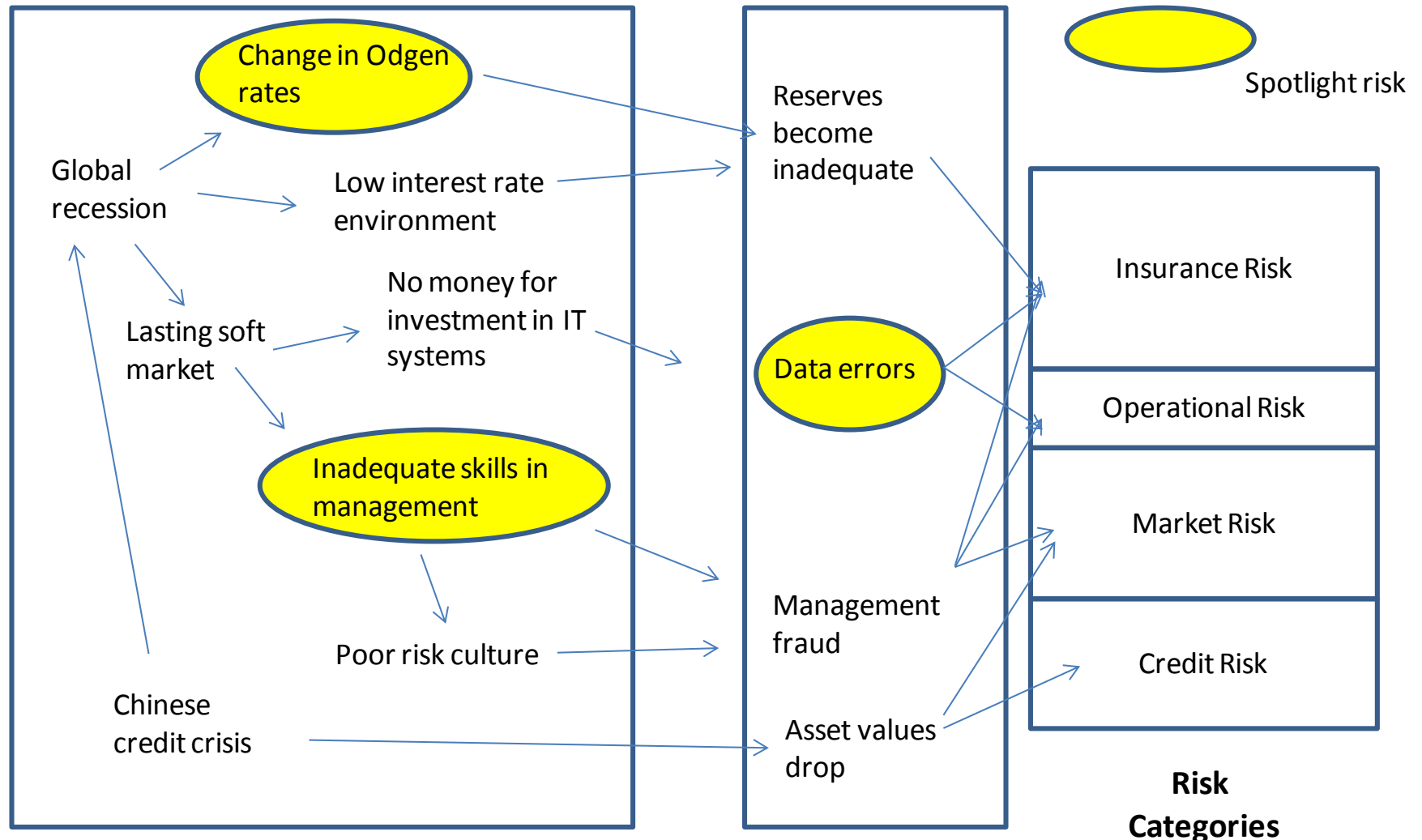
An introduction to the next three slides...

- Slide one: A term we have been using within the working party is a '**spotlight risk**' to help shine a light on risks. A spotlight risk is like a mini-scenario.
- Slide two: A **complex web of causes and events** is reinforced on this slide.
- Slide three: We realised that it was easier to think of elephants as **scenarios** or inter-connected causes and events.

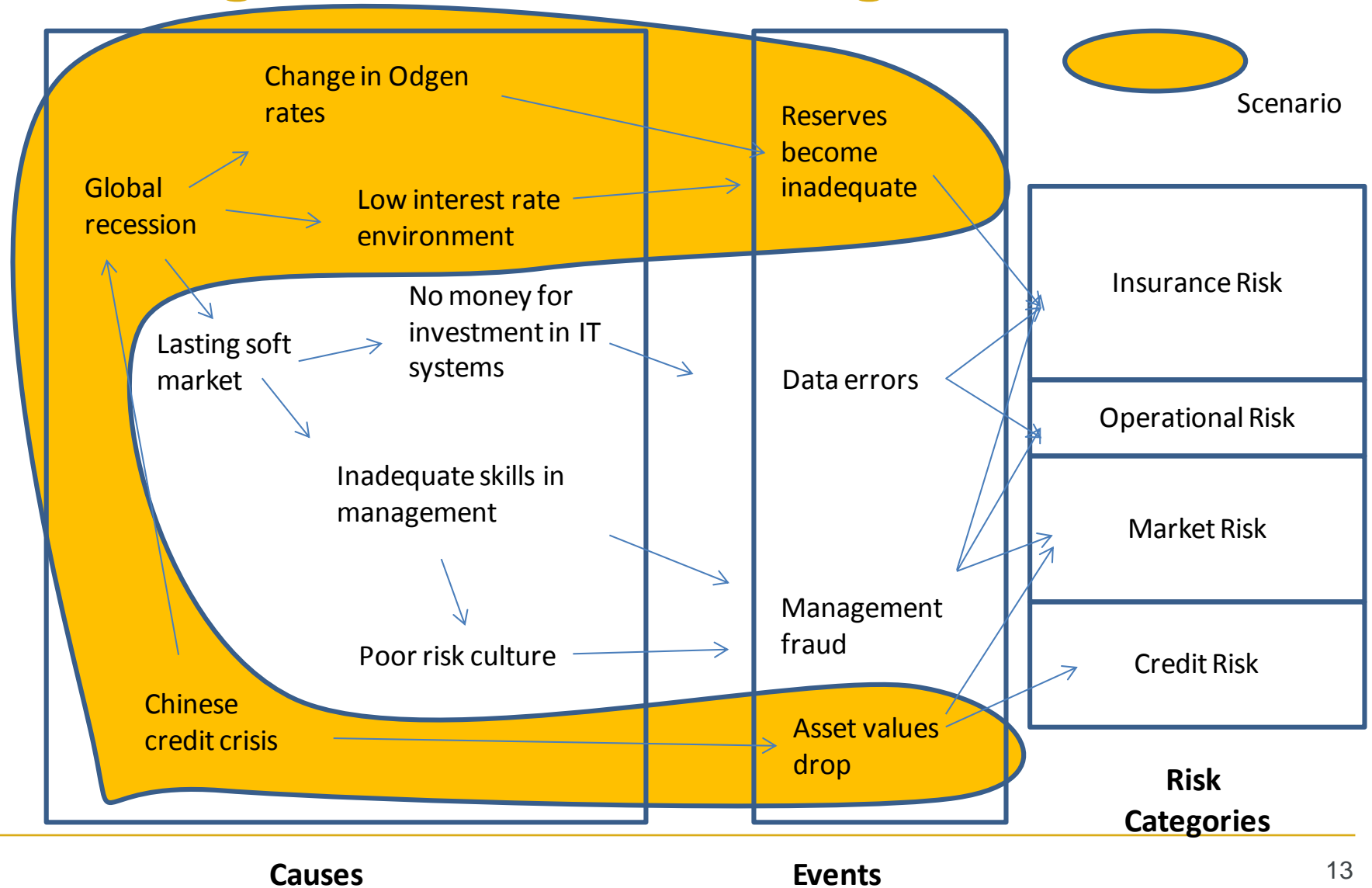
Risk lineage: Spotlight risks



Risk lineage: Cause and events



Risk lineage: Scenario building



Risk lineage: Back to definitions

“Risks are the uncertainty around manifestation of scenarios or related causes/events that may impact our business...”

“Risk *elephants* are the uncertainty around manifestation of scenarios or related causes/events that may impact our business *and that we’re not currently talking about effectively...*”

Risk lineage: An example

- Let's consider a change in UK government
 - No more Solvency 2 as we withdrawal from Europe.
 - Financial market volatility across asset classes such as property, equity and bonds.
 - Perception of government biases may change interest rate or value of sterling.
 - Tougher view on treating customers fairly through the FCA may deteriorate loss ratios or cause fines.
 - Change of policy on industry issues such as Flood Re or Pool Re.
- **Which of these are elephants and which aren't?**
- **Which of these are causes/events and which are risks?**

Quality in discussion

- What is a good discussion?
 - A good discussion has an appropriate level of detail for the audience concerned.
 - It allows a transfer of knowledge and subsequent challenge.
 - It engages participants on topics that are relevant to them.
 - They understand the purpose of ERM a little bit more afterwards.
- Are our risk discussions this good?
 - Some are good and some bad.
 - In particular, most risk practitioners would agree that engagement has a long way to go for the wider business to really value ERM.

Barriers that lead to Elephants

- We considered that there were some significant barriers:
 - Risk culture
 - Complexity
 - Communication
 - Management myopia
 - Over reliance on quantification
- This section of our work is not yet completed and will be detailed further in the final paper.

So what?

- We've been talking about some elephants here, so perhaps you could do the same back in your company - risk awareness is a large part of the challenge.
- Risk, being a relatively new area is still benefitting from the creation of a consistent language. We've spent some time defining language a little and this should help.
- We've also discussed barriers. These are tough to bring down but can be tackled step by step.



Questions



Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.



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