Optimizing and balancing corporate agility for insurers

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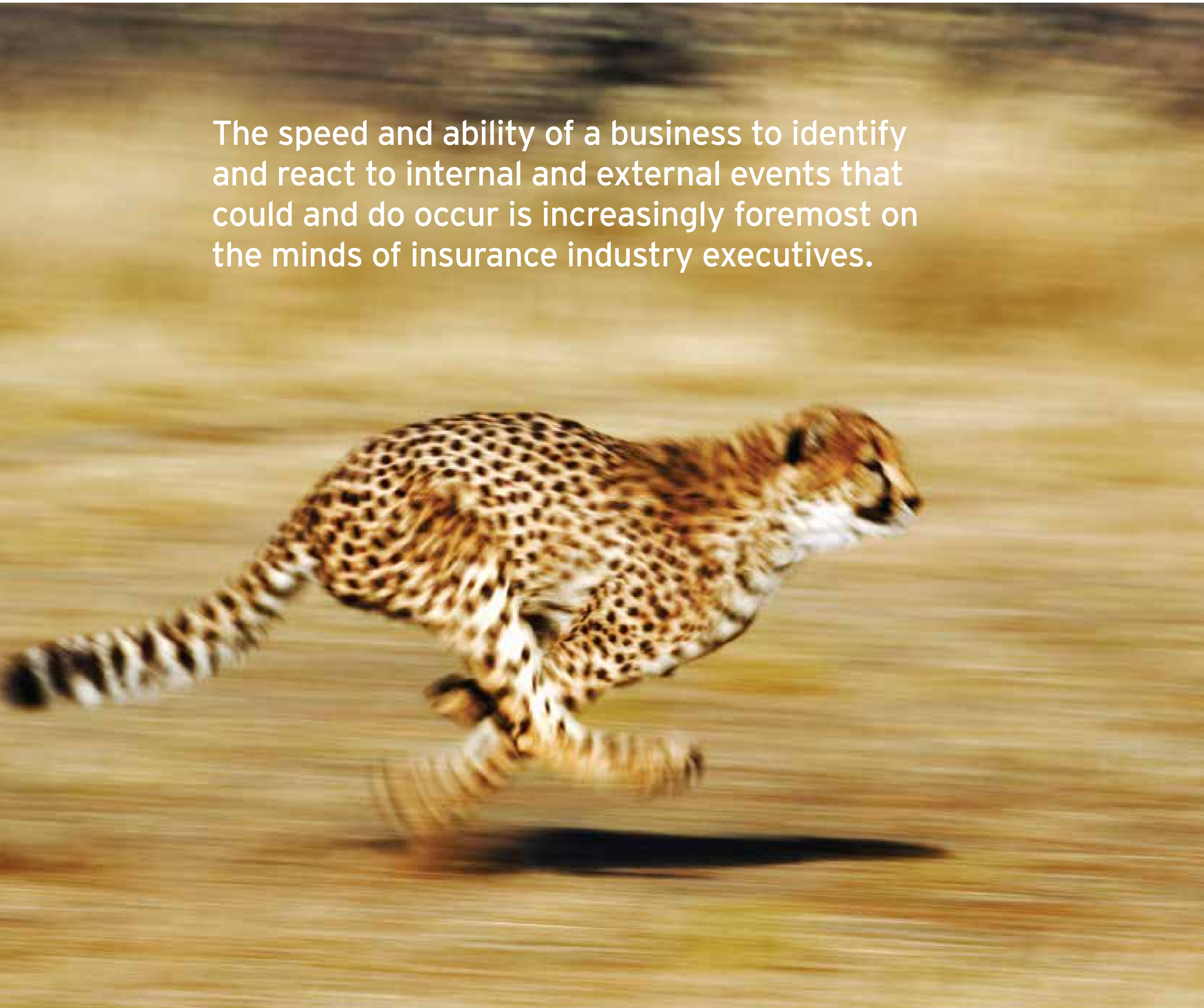

The speed and ability of a business to identify and react to internal and external events that could and do occur is increasingly foremost on the minds of insurance industry executives.

Executive summary

Linking formalized risk management activity with strategy continues to be a challenge for organizations in both planning and implementation. Although Solvency II encourages the linkage of the risk management system and internal model to strategic decision-making, it is our experience that there is still no consistent approach being used across the market. There is also a lack of consistent involvement by risk management professionals in those activities that do take place.

Our conversations with chief executive officers and chief risk officers increasingly turn to strategic uncertainty and how it can be managed as effectively as possible. The dialogue deals less with compliance and more with the broader benefits and business value that can be derived. It is no surprise that this topic continues to gain momentum in an economic environment that is uncertain due to recessionary pressures, sovereign debt, the situation with the euro and many other factors.

In this paper, we discuss the importance of strategic uncertainty and propose a structured approach to assessment that directly links risk management components to strategy. We suggest practical steps insurance companies can take to improve and optimize strategic risk management to achieve their overall goals.

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Addressing strategic uncertainty

Having a good strategy — and executing it properly — is critical for success; however, that may not be enough.

The unpredictability of the non-linear systems that permeate the marketplace is a key reason why people and organizations buy insurance in the first place. However, it also means that strategic uncertainty is guaranteed for most insurance businesses for the risks they underwrite and other types of risk they face. In a world where corporate interconnectivity and system complexity continue to grow, the non-linear nature of the systems influences frequency and severity of known risks and emerging risks that may not yet be well understood.

People and organizations sometimes differentiate between "pure" uncertainty and other factors affecting their awareness and readiness to deal with business challenges. The acronym VUCA is sometimes used to refer to the volatility, uncertainty, complexity and ambiguity associated with business conditions and situations (Appendix 3). This can be a useful way to structure strategic thinking around uncertainty and other related terms and concepts included in the VUCA model. Demographic shifts, changes in beliefs or values, geopolitical trends and vulnerability to crises are all examples of forces which drive VUCA components.

Whichever way it is addressed, uncertainty cannot be completely removed, but it can be understood in a strategic context to provide better information for the decision-making process. Moreover, organizations can often improve their ability to deal with uncertainty (either now or in the future), which is one of the reasons why Solvency II introduces new requirements around this topic. It makes sense for insurance companies to periodically reconsider the way in which they deal with uncertainty: the methods used and people involved. The introduction of Solvency II may provide an external stimulus for some organizations to refresh their approach.

Recent developments related to scenario planning have highlighted that, for some insurers, smarter approaches can be taken in dealing with much of the risk and uncertainty that can deter the success of even the best laid plans. A good example is the action taken in relation to scenarios involving sovereign default. The impact of an event was not only considered in a direct way, but also in the context of what else might happen that would limit the availability of additional funds.

Structuring assessments of strategic uncertainty

Most companies face strategic uncertainty, however, definitions relating to the term can be loose and inconsistent. "Strategic risk" is a related phrase sometimes used, but often with a different meaning. Some examples are included in the diagram below and explained further in Appendix 1:

From a risk-management perspective (no matter how strategic uncertainty is defined), it is beneficial to use a structured approach to assessment which directly links risk management components to strategy.

Strategic risk assessment (and other aspects of strategic risk management) can be complex and sophisticated in practice. We agree that it should be, although subject to an economic limit (i.e., do not spend too much time assessing risk that does not pose much of a threat). Nonetheless, simple approaches can be used to demonstrate how such assessments can be structured.

The following diagram illustrates how a classic strategic value driver model (explained in Appendix 2) can be used to identify key areas of uncertainty that could have a positive or negative effect on achieving overall strategy.

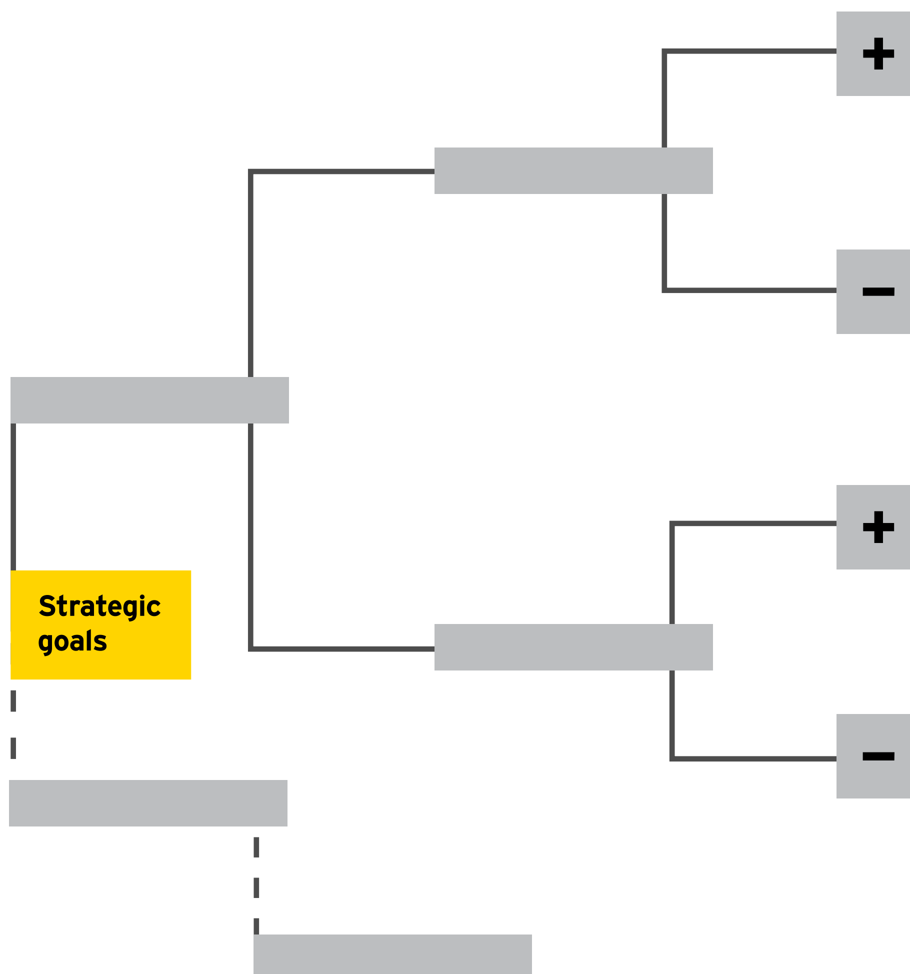
Organizations that undertake this approach have an understanding of some of the main drivers of strategic uncertainty. Managing and executing strategy with due regard to these uncertainties is critical and would appear to be an important part of increasing the chances of strategic success.

Consider the key strategic uncertainties

Value drivers
(things we need to get right to achieve strategic goals)

Value levers
(tangible items supporting each driver)

Key uncertainties
(that could positively or adversely affect performance of each lever)



Corporate agility in successful execution of strategy

Some organizations do not need to be agile to successfully implement strategies because risk and uncertainty is such that distracting events (internal or external) do not always occur. Some insurance companies are arguably set up to operate in a non-agile way. Their business models are not particularly complex (i.e., few classes, focused on a very clear and specific market segment). Principal uncertainty is based on external insured events that are beyond the control of the business (although the extent of their exposure is well within their control).

However, larger insurance companies with more complex business models can be subject to greater uncertainty. As a strategic, and in some cases tactical, response to that issue, they may have a desire to be more agile in the products and services they offer. Overall, levels of uncertainty do not necessarily correlate to scale and business model complexity. However, the effect of non-linear systems in larger companies with more people, products and customers means that uncertainty needs to be managed well—especially during periods of change when it can be more difficult to achieve results.

If corporate agility can be described as the speed and ability of a business to identify and react to internal and external events that could and do occur, then these two separate talents ("identify" and "react") can be applied in a strategic context and attached to the strategic driver model highlighted earlier.

By estimating the effect of corporate agility, the company can consider its appetite for variability against its strategy, and make decisions regarding what action should be taken to address the level of strategic variability.

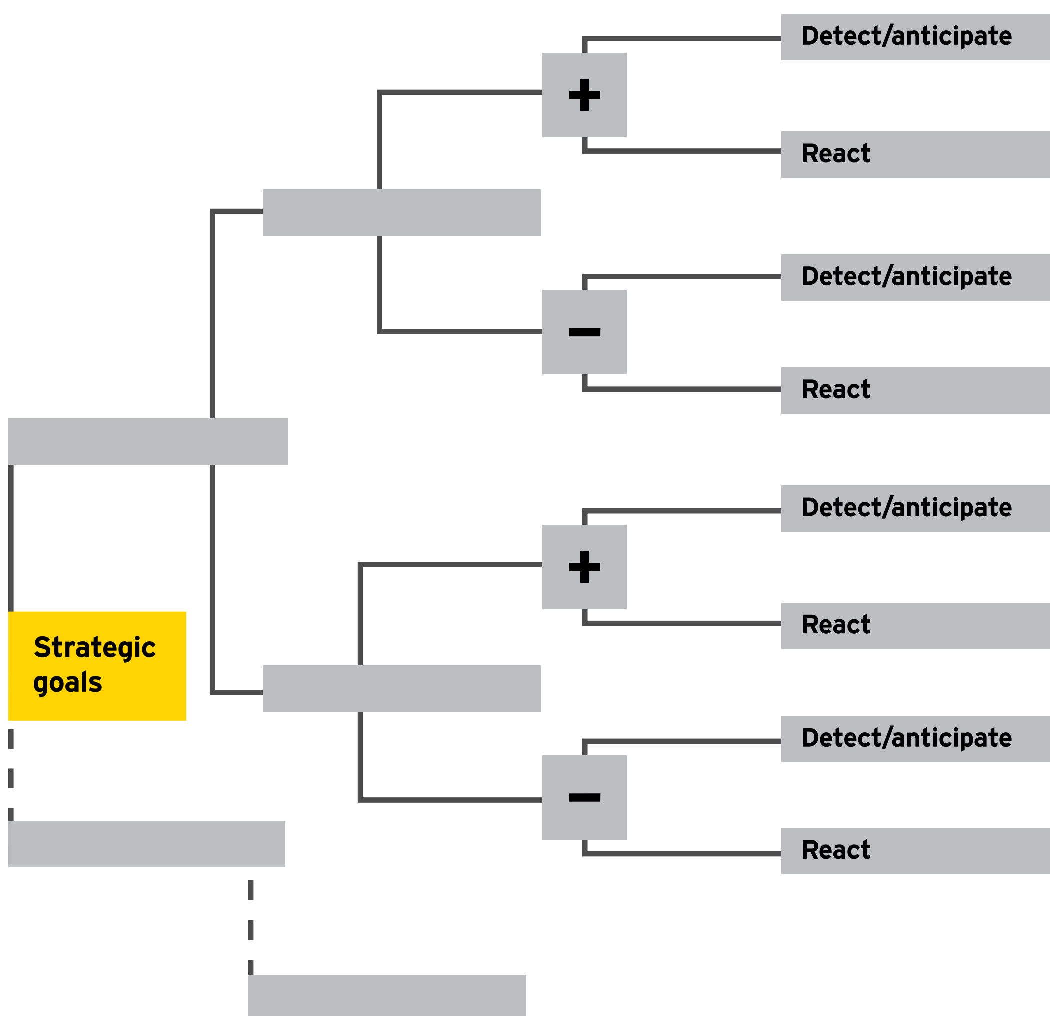
Assess ability to detect/anticipate/react to things that could make an impact

Value drivers (things we need to get right)

Value levers (tangible items supporting each driver)

Key uncertainties (that could positively or adversely affect performance of each lever)

Agility factors (assessment of things which give us capability to ....)



Taking action

Successful identification and evaluation of these uncertainties can create more work. When an aspect of uncertainty may have a direct effect on strategic success, businesses tend to want to do something about it.

Whether those actions relate to a better assessment of the risk, an improved detection capability or an increased ability to react, opportunities will arise. These actions can take time and cost money. Therefore, the economics of improvements should always be considered even if the nature of the uncertainty could make this difficult to do in practice.

Proposed actions for other risk management activity can also be considered. On the one hand, lack of data and models supporting the levels of uncertainty might mean that some organizations would rather spend money on risks that are easier to quantify or model. Alternatively, the ability to demonstrate why and how certain risks do or could directly influence the achievement of strategy can be a powerful director of resources. The rationale for making this a priority and the potential impact on the strategic success of the business can be addressed at the highest level in the organization.

In understanding corporate agility, it is important to remember that sometimes (especially for "black swan" scenarios) decisions will need to be made and actions taken against a backdrop of chaos, ambiguity and heightened stakeholder scrutiny and tension.

Some might argue that, at first glance, the insurance industry is not one that moves at a fast pace and that the need for strong corporate agility is not particularly high. At a more micro level though, there are many examples (such as Hurricane Katrina, and in the first 12 months of the financial crises and beyond) where businesses would like to have been able to respond faster to avoid issues or to exploit situations. In some cases, the value of better corporate agility is only recognized in retrospect but it can be identified in real-time or in advance. Although insurance companies may not need to be as agile as some industries, there is opportunity for progress and an appetite for greater agility in some organizations.

Obtaining benefit from investment in other components

The attachment of uncertainty or variability components to a strategic value-lever-model can be useful and provides a good understanding of how key uncertainties influence the achievement of strategic goals. However, further benefit can be obtained through the linkage between this analysis and other risk management framework components.

In our paper, *Measuring up: effective risk management in insurance companies* (June 2011), we provided a mechanism for understanding and navigating factors which influence risk management effectiveness. This applies to risk management in a broader sense: people, applications and insurance company processes, such as underwriting, claims management and purchasing reinsurance.

For corporate agility purposes, insurers will be interested in the extent to which the framework components may be used to improve the speed or quality of a company's detection of/or response to events (sometimes through the use of formalized key risk indicators).

Stress and scenario testing, reverse stress testing and contingency planning are examples of existing risk management activities that can provide useful input to the assessment of a company's agility. Therefore, whether the interest relates to strategic uncertainty or more day-to-day uncertainty, the framework provides a good map of risk management activity that can be considered for its ability to improve agility.

Align risk management framework components to agility factors

Value drivers (things we need to get right)

Value levers (tangible items supporting each driver)

Key uncertainties (that could positively or adversely affect performance of each lever)

Agility factors (assessment of things which give us capability to ....)

Supporting risk management components (which contribute to the quality of the agility factors)

Practical steps for improving strategic risk management

Which comes first: the strategy or the strategic risk assessment? Theoretically, how can one set strategy without properly understanding the associated risks? We would suggest that more companies have a strategy than a formalized strategic risk assessment. Most insurers undertaking assessments are likely to be attaching the assessment to the existing strategy, with the opportunity to revisit the issue at the next review.

There is a pragmatic way to optimize the management of strategic uncertainty. Prior discussions with senior executives on this topic suggest the following steps:

- Ensure the value-driver levers for the existing strategy are clear—individually and collectively
- Identify and evaluate, using scenarios, uncertainties that could make it easier (or more difficult) to operate the value levers effectively; and consider the likely impact of how those uncertainties are managed
- Analyze the company's ability to detect and anticipate internal or external events that would impact the value drivers
- Evaluate the company's ability to respond at the appropriate pace to potential events that might occur
- Understand risk management capabilities and the contribution made to the corporate agility factors
- Prioritize improvements and optimize corporate agility in relation to strategic risk and uncertainty

Optimizing strategic risk management

Value drivers (things we need to get right)

Value levers (tangible items supporting each driver)

Key uncertainties (that could positively or adversely affect performance of each lever)

Agility factors (assessment of things which give us capability to ....)

Supporting risk management components (which contribute to the quality of the agility factors)

Strategic goals

+ Detect/anticipate
React

− Detect/anticipate
React

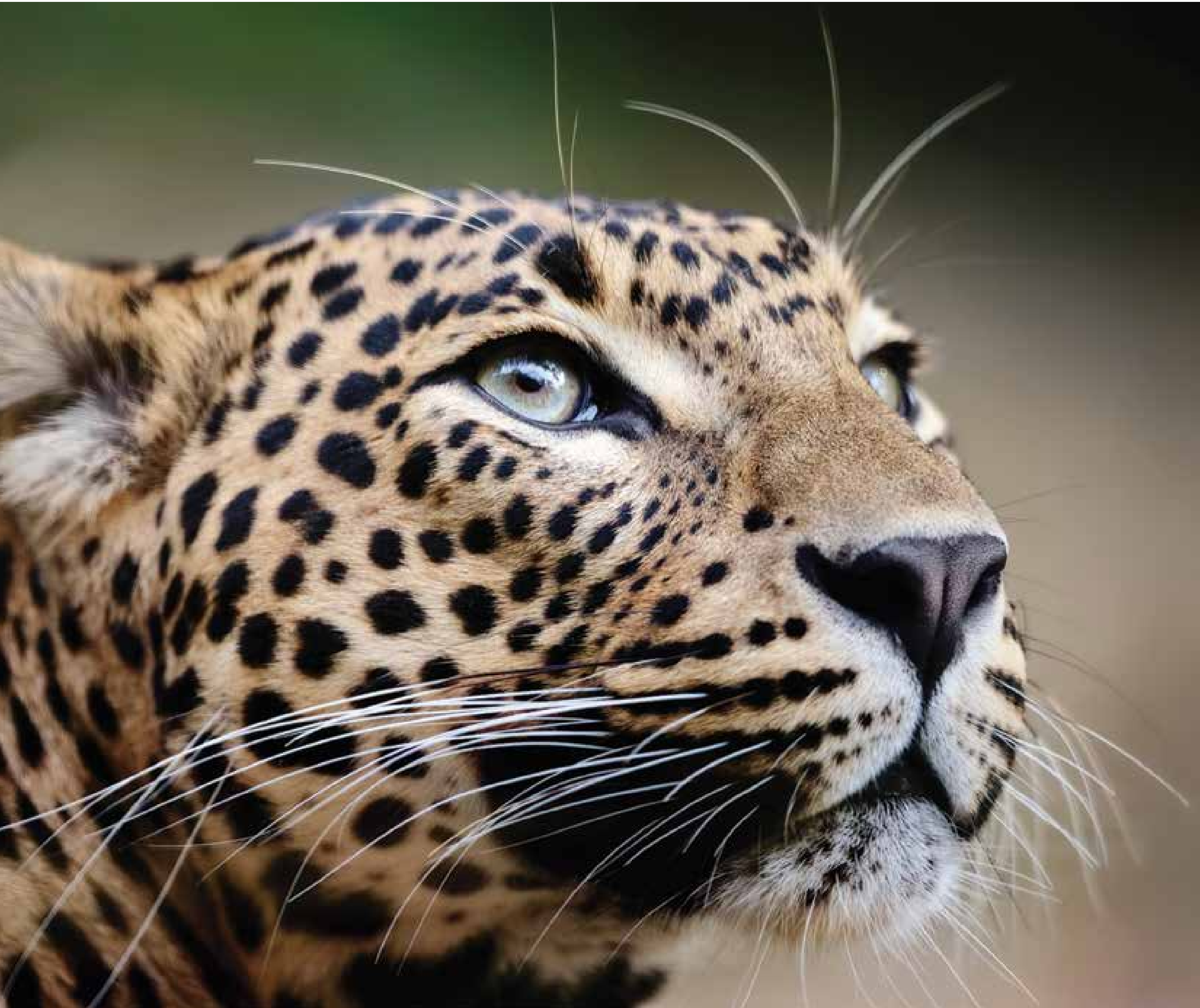
+ Detect/anticipate
React

− Detect/anticipate
React

Improvements being considered here have a direct link to achievement of strategy

Practical steps for improving strategic risk management

1. Use positive and negative scenarios to identify and evaluate uncertainties surrounding the value levers	2. Assess ability to detect/ anticipate/respond to internal and external events that could occur	3. Identify and assess the contribution made to corporate agility by risk management framework components	4. Prioritize improvement based on link to achievement of strategy



Conclusion

Corporate agility for dealing with strategic uncertainty can be better understood and enhanced as risk management collaboration between CEOs and CROs becomes more sophisticated. No doubt, strategic uncertainty continues to be a challenge for many insurance companies, particularly given the current international economic climate.

As organizations increasingly formalize their approach to dealing with this challenge, more consistent market practice and involvement of specialist risk professionals could well emerge. The approach outlined above provides some useful ideas for insurers dealing with this important topic.

Appendix 1 — explanations of strategic risk

Strategic risk is a term often used that has different meanings for various people and groups. The following table provides some further explanation of the examples given in the earlier diagram:

Examples of strategic risk definitions	**Explanation of what people often mean when they use this term**
Risk is not properly considered when defining strategy?	Work done in relation to strategic planning can cover goals and major factors that are critical to their achievement. Risk of non-achievement is considered, but not necessarily in a detailed or structured way. Thus, strategy is set without the ability to demonstrate a full understanding of the risks involved.
Risk management activities are not focused on drivers of strategy?	The risk management system and its components might be well developed, appropriate for the organization and embedded into the business. However, the system (or framework) is not explicitly applied to the drivers of strategic value and therefore, their importance to specific value drivers is not directly established.
Strategy is not "good" or well-thought through?	The quality of strategic thinking is lacking—even before the introduction of volatility and strategic risk considerations.

Examples of strategic risk definitions	Explanation of what people often mean when they use this term
Management activity does not keep up with changes in strategy?	The organization changes its strategy midway through a period to react to internal or external events. However, the people, processes and systems are not/cannot be changed quickly enough to be aligned to the revised strategy. Therefore, there is temporary misalignment of what the organization does versus what it wants to achieve.
The strategy might need to change?	After having pursued a certain strategy, the organization may need to change direction.
Consequences of non-achieving strategy?	The effect or impact (typically, the downside) on the organization if it fails to meet strategic goals. Examples include: shareholder funding withdrawal, rating agency downgrades, supervisory intervention and loss of key staff.
Uncertainty surrounding achievement of strategy?	The variability of outcomes that revolve around the strategy, and things that could occur while pursuing a particular strategy.
Incompatibility of strategic goals, strategies, resources, quality of implementation and market economics?	The strategy intended clashes somehow with the components that are important to its achievement. Inconsistency between the strategic intention and the current business environment.

Appendix 2 — explanation of strategic value-driver model

Our methodology for addressing strategic uncertainty is based on a classic value-driver-model approach which supports effective strategic decision-making and planning by linking value drivers and outcome metrics to the decisions being made.

The methodology used helps determine which items are, individually or collectively, of greatest importance to the achievement of strategic goals. This is typically generated by senior management in brainstorming sessions and often supported by existing strategy materials which already provide an indication of the relative importance of various components to overall strategy. The items might relate to people, systems, customer behavior or corporate parent support.

The items (or "strategic value drivers") assessed as being of greatest importance to achievement of strategy are linked in the diagram to a single "achievement of strategy" anchor point.

Each strategic value driver is then addressed in turn in more detail to understand the sub-items which are of greatest importance to each. The sub-items are then linked in the diagram in the same way as the drivers.

This can be iterated until there is a sufficiently granular image of the linkage between value drivers and achievement of overall strategy. This is useful for management in understanding how decisions made in relation to a sub-item might affect overall strategy.

Our methodology builds upon this picture by attaching key uncertainties, agility factors and risk management system components to the sub-items — thus demonstrating the linkage through to the achievement of overall strategy.

Appendix 3 — further explanation of VUCA

The VUCA model can be used to navigate factors and dynamics associated with volatility, uncertainty, complexity and ambiguity. Businesses can use the model when looking ahead to understand what might cause corporate value to change and how best to manage those factors. A common definition of the four components appears below.

Components	Definition
V=volatility	The nature and dynamics of change and the nature and speed of change forces and change catalysts
U=uncertainty	The lack of predictability, prospects for surprise, and the sense of awareness and understanding of issues and events
C=complexity	The multiplex of forces, the confounding of issues and the chaos and confusion that surround an organization
A=ambiguity	The haziness of reality, potential for misreads, and the mixed meanings of conditions; cause-and-effect confusion

Appendix 4 — Optimizing strategic risk management

Value drivers
(things we need to get right)

Value levers
(tangible items supporting each driver)

Key uncertainties
(that could positively or adversely affect performance of each lever)

+

–

+

–

Strategic goals

Agility factors
(assessment of things which give us capability to ....)

Supporting risk management components
(which contribute to the quality of the agility factors)

Detect/anticipate

React

Detect/anticipate

React

Detect/anticipate

React

Detect/anticipate

React

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