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Management Behavior and Decision Making: The Critical Underpinning of An Insurer's Enterprise Risk Management and its ORSA Compliance

The most recent update of the NAIC's OWN RISK AND SOLVENCY ASSESSMENT (ORSA) GUIDANCE MANUAL, (December, 2017) states that "an effective ERM framework (for an insurer) should, at a minimum, incorporate the following key principles":

- Risk Culture and Governance – Governance structure that clearly defines and articulates roles, responsibilities and accountabilities; and a risk culture that supports accountability in risk-based decision-making.

- Risk Identification and Prioritization – Risk identification and prioritization process that is key to the organization; responsibility for this activity is clear; the risk management function is responsible for ensuring that the process is appropriate and functioning properly at all organizational levels.

- Risk Appetite, Tolerances and Limits – A formal risk appetite statement, and associated risk tolerances and limits are foundational elements of risk management for an insurer; understanding of the risk appetite statement ensures alignment with risk strategy by the board of directors.

- Risk Management and Controls – Managing risk is an ongoing ERM activity, operating at many levels within the organization.

- Risk Reporting and Communication – Provides key constituents with transparency into the risk-management processes and facilitate active, informal decisions on risk-taking and management.

Reflecting on my 40 years in the insurance field, the last almost 20 of which have been spent incorporating Enterprise Risk Management in my senior management, rating agency and college teaching activities, I am in strong agreement with and a staunch supporter of the ORSA process, the description and goals of which are:

The ORSA, which is a component of an insurer's enterprise risk management (ERM) framework, is a confidential internal assessment appropriate to the nature, scale and complexity of an insurer conducted by that insurer of the material and relevant risks identified by the insurer associated with an insurer's current business plan and the sufficiency of capital resources to support those risks.

1. To foster an effective level of ERM at all insurers, through which each insurer identifies, assesses, monitors, prioritizes and reports on its material and relevant risks identified by the insurer, using techniques that are appropriate to the nature, scale and complexity of the insurer's risks, in a manner that is adequate to support risk and capital decisions; and

2. To provide a group-level perspective on risk and capital, as a supplement to the existing legal entity view.

What I have found, in the course of extensive research I have done outside of the insurance industry, is that theories and findings from the field of Behavioral Economics shed valuable light on how insurers can make better business decisions and manage better … guiding their companies to devise and execute more effective strategies with lower risk exposures, and safeguard their capital.

Over the past several years, I have become familiar with the work of the acclaimed Israeli psychologists Amos Tversky and Daniel Kahneman going back to the 1960s (read "*The Undoing Project*" by Michael Lewis), and a disciple of theirs, Richard Thaler. They came to many groundbreaking conclusions in the field of Behavioral Economics that challenged the veracity, logic, and objectivity of decision-making. Kahneman and Thaler won Nobel Prizes (in 2005 and 2017, respectively) for their work over many decades, in significant part examining how human beings made decisions (Tversky passed away in 1989). In the process they challenged the notion of the rational man and demonstrated the widespread presence of biases and lack of rigor . . . and in many cases downright foolishness . . . in decision-making. The esteemed risk expert (and all-around renaissance man) Nassim Taleb came to several similar perspectives, many described in his important work "*The Black Swan"*. I wrote a book in 2018, "*Better Behavior + Better Decisions = Less Risk*", and its thesis is that Kahneman's and Thaler's findings can be applied to management behavior and decision-making to enhance the art and science of risk management.

I do not believe that my thesis of the importance of incorporating human behavior and the illogic of decision-making in building and managing an effective ERM process counters in any way the historic use of analytics in risk management, nor do I intend to challenge it. Just the opposite . . . awareness of the potential biases and illogic of decision-making ***in combination*** with well-conceived risk management analytics and processes significantly adds to the effectiveness of risk management.

Some practical examples of how the principles of Behavioral Economics can be applied to successful Enterprise Risk Management thinking and processes are as follows:

Having the right mind-set for risk management

For ERM to be performed effectively at an insurer to succeed in its invaluable role it is imperative that a number of positive behavioral dynamics are in place. This "organizational mind-set" is necessarily established at the top; a necessary condition for a risk management process to be successful is that the CEO unconditionally believes in it and ***actively*** supports it. This concept goes beyond ORSA's "Key Principle #1: Risk Culture and Governance – Governance structure that clearly defines and articulates roles, responsibilities and accountabilities; and a risk culture that supports accountability in risk-based decision-making". It requires engaged participation and reinforcement . . . meaningful leadership, not merely "lip service." Continuing, the entire organization, at least from the CEO's staff down to middle management (and ideally further), needs to both understand the importance of an effective risk management process and be committed and involved via active participation, monitoring, and encouragement. The well-known adage "People do what's inspected, not expected" applies here. A strong motivator is to have a risk management component included in employees' performance evaluations, and for management in their incentive-compensation packages as well.

Understanding consumer thinking and behavior, and meeting consumer expectations … and therefore reducing risk:

Thaler concluded during his decades of research that people were often not rational in their thinking and decision-making, influenced he believed by a number of biases. As such, he theorized that many buying decisions were also not rational, and it follows that understanding consumer buying behavior ***as it actually occurs*** was critical to strategic success.

Given, therefore, that strategic success is quite possibly driven by some level of irrational consumer behavior, what risks are present for corporate executives as they develop and market products selected to succeed in light of (*or in spite of*) this behavior? Put another way, ***how can corporations identify and understand potentially irrational consumer behavior and satisfy it, while identifying and then mitigating the risks inherent in not satisfying this behavior*?** On the other hand, could it be possible that much consumer behavior is not at all irrational but that the thought processes behind this behavior are not accurately understood?

The legendary Harvard professor and marketing expert Theodore Levitt has provided many groundbreaking theories as to why consumers make the choices they do. In his book "*The Marketing Imagination"*, Levitt posits that "**people don't buy *things*, but buy *solutions to problems***." Professor Raymond Bauer, also from Harvard, pointed out that "when buyers select a known vendor or known brand over another it is more meaningful to ***think of the choice as an act of risk reduction rather than as an expression of a brand preference*.**"

For insurers, looking at the products they offer as solutions first and foremost, and having products approved by the NAIC's Interstate Insurance Product Regulation Compact second, provides valuable guidance to meeting consumer needs with less "friction" and overall risk.

During my tenure as one of the founding faculty members of Columbia University's Enterprise Risk Management department, I developed and taught a course entitled "Company Failures". The underlying premise of the course was "Given that so much is written about corporate success stories, why do so many companies fail?" Underlying this premise, a critical path of exploration was to identify risks companies that failed were exposed to that were not mitigated. One of the common risks I found in the course of my and my students' research is that companies that failed more likely than not did not understand their customer's thinking and behavior, ***and didn't know that they didn't!***

Determination of risk tolerance:

All who are interested in enterprise risk management agree that understanding and quantifying/qualifying an insurer's tolerance for risk is critical to its success and avoidance of failure. Many ERM practitioners have developed frameworks for determining an insurer's tolerance for risk. I offer the following approach, with two introductory thoughts:

Risk tolerance defined: How much adverse risk impact will a company accept in the course of its business?

Adverse risk impacts are either financial (or that have impact on a company's financials) or reputational in nature. Companies have no tolerance for reputational risk.

1) The critical questions for an insurer to consider are:
   - Who is impacted if a company is subjected to too much adverse risk impact?
     Stakeholders ... those who have a vested interest in the company:
     Customers, Producers, Board of Directors, Investors/Shareholders, Rating agencies, Regulators, Counterparties ... Financial, Business partners, Supply chain participants, Executives/Management/Critical staff)
   - What "***triggers***" will stakeholders react to, causing them to potentially change their relationship with the company in a manner that is unfavorable to the company?
     * Adverse financial outcomes: capital, earnings
     * Business line inadequacy (product, service, advice/information)
     * Rating downgrades
     * Business conduct/reputational impairment

- What ***decisions*** will stakeholders make that the company won't like?
  * Cease doing business with the company, or diminish the volume of business they do with the company:
    Customers, producers, counterparties (financial, business partners), supply chain Participants, executives/management/critical staff
  * Enhance their terms/diminish your terms in your transactions:
    customers, producers, counterparties (financial, business partners), investors/shareholders supply chain participants (Price/cost/rate, remuneration)
  * Impose more onerous governance determinations/requirements/implications:
    Rating downgrades, additional regulatory requirements

2) A company's risk tolerance in the aggregate is the extent to which its (i) adverse risk impacts … financial or reputational … caused by its (ii) strategies and potential threats are below that which will lead to (iii) unfavorable triggers that (iv) disenfranchise stakeholders to an unacceptable extent.

3) Once companies determine the extent to which stakeholders will be disenfranchised enough to change the way they interact with the company, it is imperative for them to evaluate their strategies and potential threats to see if any can cause scenarios with adverse risk impacts beyond what the company is willing to tolerate.

In closing, I encourage insurance executives to think of risk management before the ORSA activities are executed and reported on. Risk can be substantially reduced by making better decisions from the point of strategy creation and forward, and by managing more effectively.

My book, "*Better Behavior + Better Decisions = Less Risk*", is available from Amazon and Barnes and Noble. Excerpts from the book have been incorporated into the above discussions.

I would be happy to discuss these ideas at your convenience; these discussions with me have no risk!