



Institute  
and Faculty  
of Actuaries

# Risk: Elephants in the Room

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

Buu Truong  
Insight Risk Consulting

14 September  
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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?

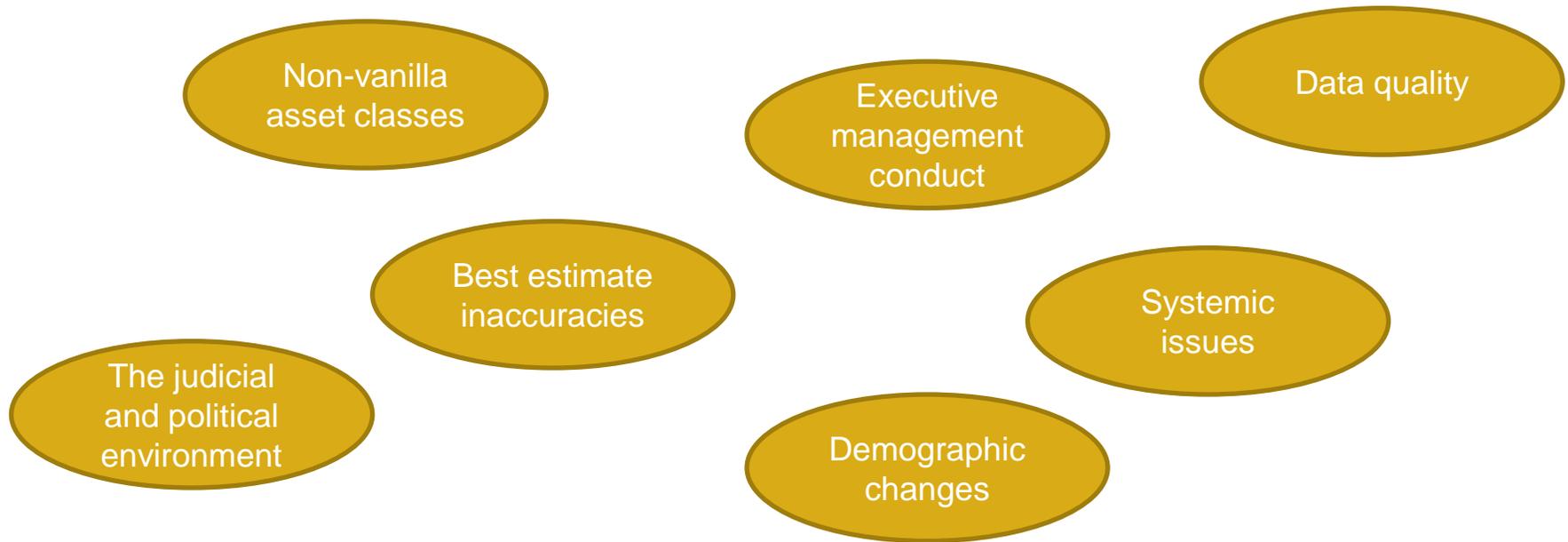
## AUDIENCE EXERCISE

- 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

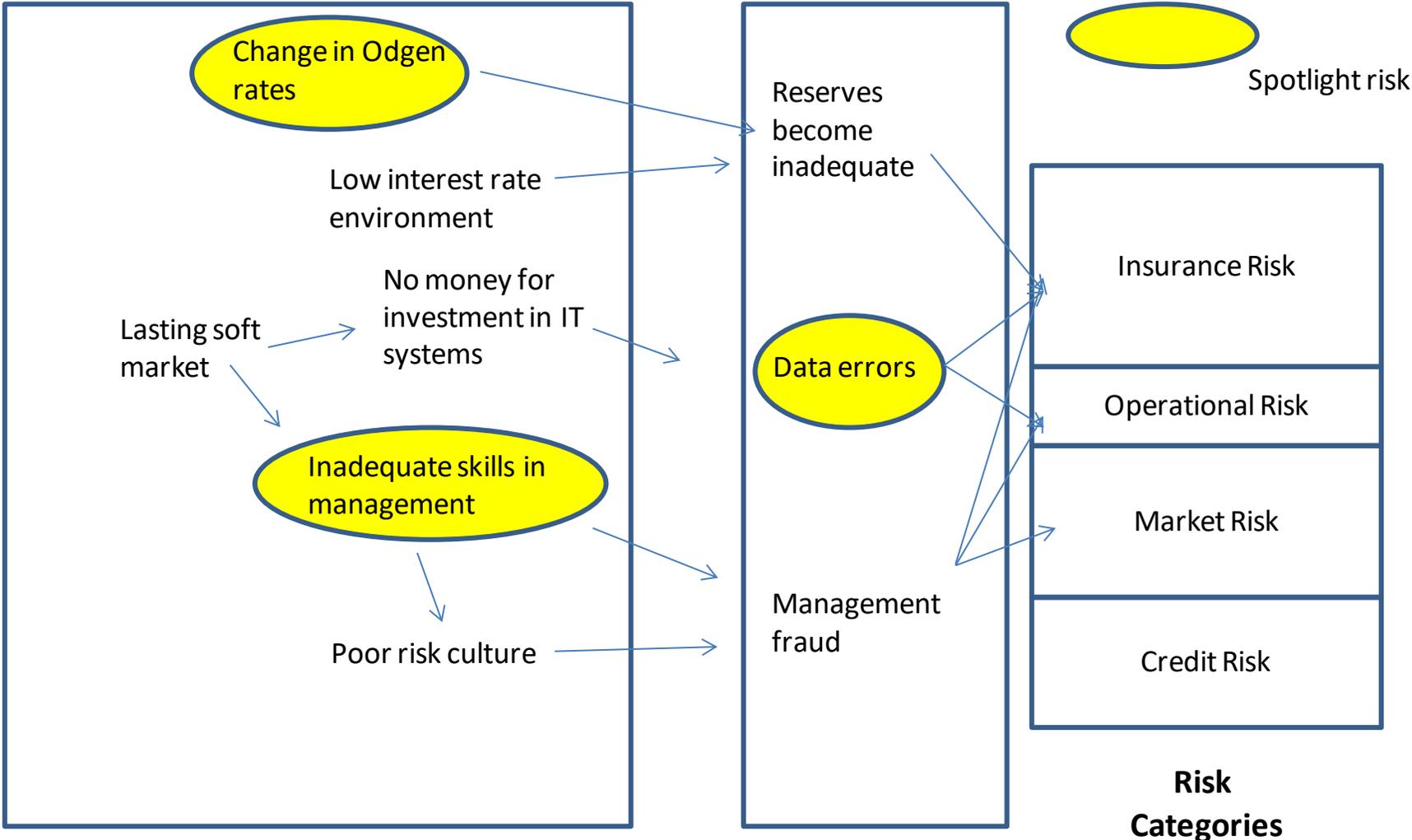
- When we started thinking about risk elephants, we thought they may be new risk categories like insurance or market risk.
- **We now feel they are uncertainties around scenarios or related causes/events which are later reported using risk categories.**
- Risk lineage may feel like a bit of a digression, 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

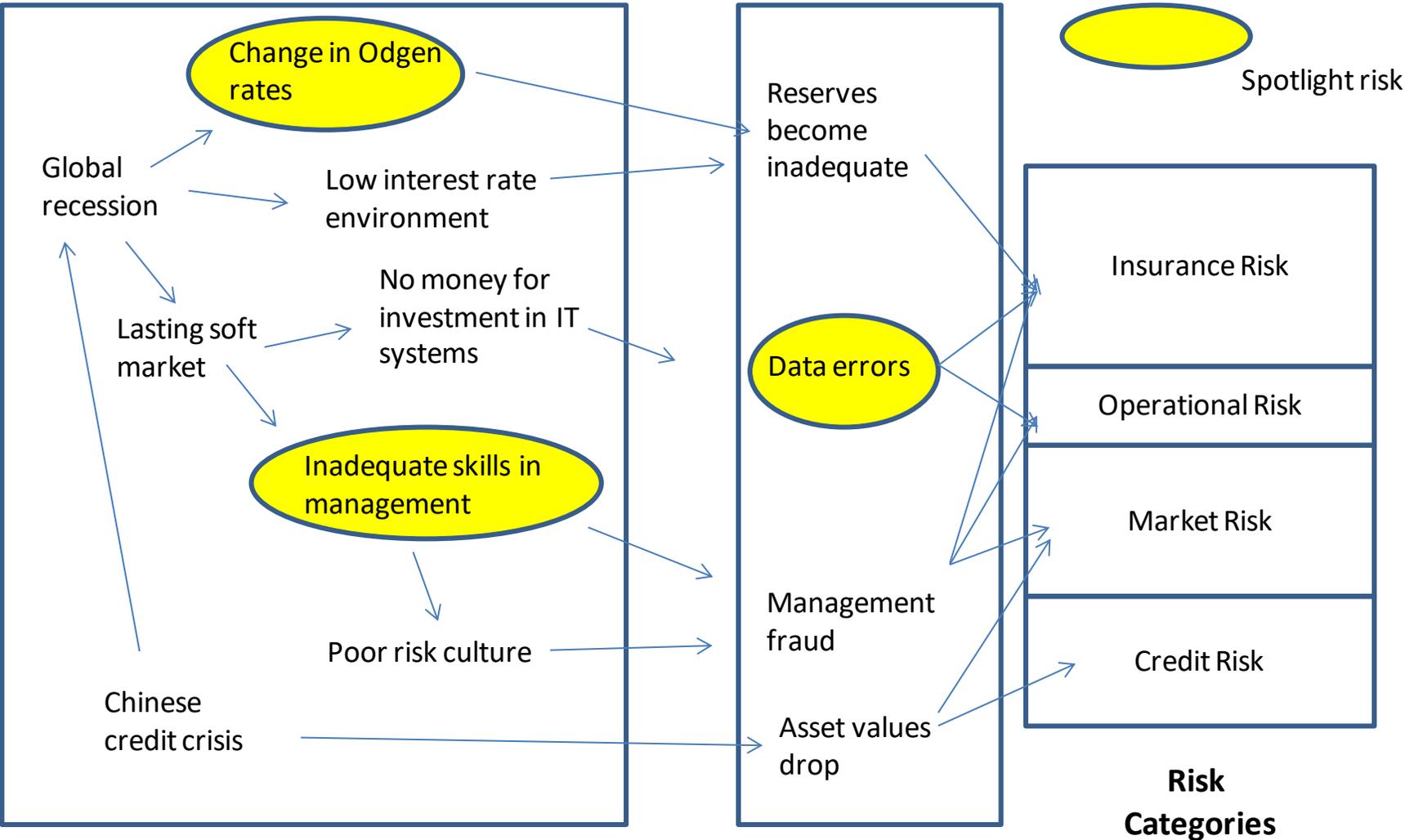


Causes

Events

Risk Categories

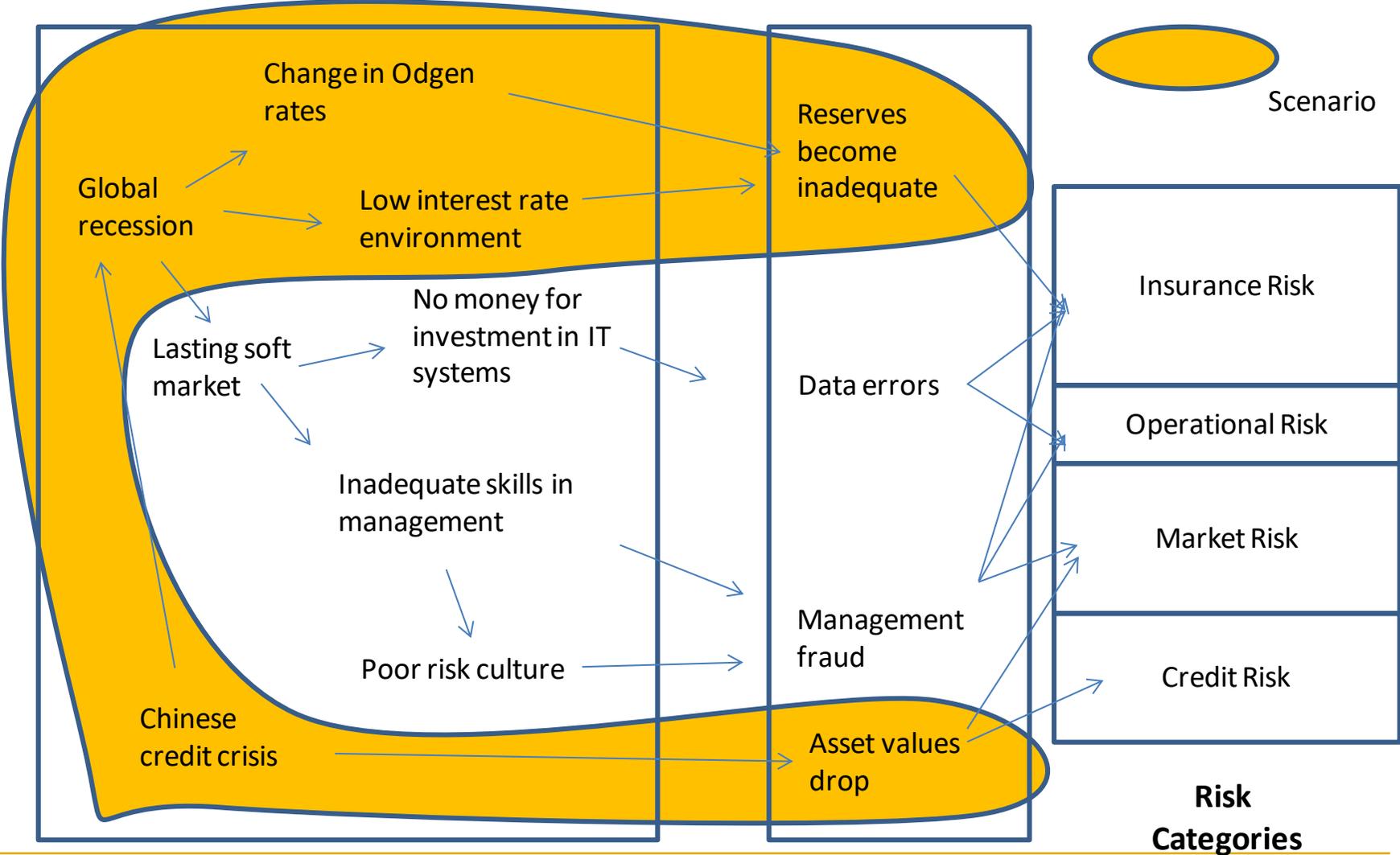
# Risk lineage: Cause and events



Causes

Events

# Risk lineage: Scenario building



Causes

Events

Risk Categories

## 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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