Reputational and Regulatory Risk Management in Life Insurance

By Bhudolia, Manoj
& Pahwa, Khushwant

Abstract

Traditionally, the role of actuaries working in life insurance companies have been more or less directed in the area of product development, valuations etc wherein they concentrated mainly at managing financial risks. By applying their knowledge in probability, statistics, risk management theories and financial principles, they try to quantify future risks and take appropriate steps to mitigate them. But with the advancement of time, the actuaries are being increasingly recognised as a guardian of an organisation's overall risk management activities, and not just the financial risk management activities. This role makes actuaries the CEO's valued ally in achieving sustainable growth over the long run. This requires actuaries to start thinking beyond the management of 'core insurance risks' and also consider some of the very important but non – quantifiable risks within their risk management ambit.

In this paper, we discuss two such very important risks facing an insurance company viz. **Regulatory Risks** and **Reputational Risks** which are arguably as risky as some of the other core insurance risks, but have largely remained out of actuarial domain till now. We will discuss these risks with context to Indian insurance industry.

Key Words

Risk Management; Regulatory Risks; Reputational Risks

Regulatory Risks Management

Insurance industry in India is in the phase of evolution. We say this for many obvious reasons. Firstly because of the fact that India is a vast country and most of its population is still without life, health and non-life insurance. This has made India a favoured destination for insurance companies around the globe, who have entered and are **entering the Indian market to acquire more and more business in their own varied ways**. Secondly, and more importantly, because the awareness about insurance in India is very low and a vast majority of current and potential **insurance consumers in India do not possess understanding of insurance products**. This also makes them a likely victim of mis-selling at the time of buying insurance products. All this necessitates the presence of governance (perhaps in form of regulations, laws and regulator) in the insurance market to ensure that the trade is carried out in a fair, equitable and ethical manner.

But while governance exists in the markets to ensure that all good things exist and bad things don't, it is important to realize that it **brings in certain costs and risks** as well for the ones being regulated. While costs include the compliance costs, the risks include the **risk on non – compliance and the risk of introduction of new regulations or changes to existing regulations**. These risks may affect the smooth functioning of the organisation and may have major cost implications for the organisation. The most recent and prominent examples of regulatory changes which had major implications for life insurers in India include the introduction of ULIP guidelines and removal of actuarially funded products.

While we agree that these changes were initiated by the regulator to bring in more standardization to the insurance market, no one can deny that these have had major cost implications for insurers as they resulted in revision in the entire product portfolio, incurring of huge costs in training the entire manpower, updating the system etc. Another major cost which arises and needs to be recognized is the imputed cost measured in terms of loss resulting from the disruption caused to the functioning of the business due to introduction of some new regulation or change in some existing regulation.

Leave aside these major regulatory changes, even minor changes to regulations can throw up some decent compliance costs for the organization like the costs of changing the IT system, updating sales literature etc.

Thus, regulatory risk refers to the risks, costs and problems arising from new regulations/laws or modification to existing regulations/laws and is one of the greatest strategic challenges facing insurance industry today. We believe that measuring and monitoring regulatory risks is equally critical as some of the other core insurance risks, because once an organization does not comply with some new regulation or a change in regulation, it falls out of the regulatory favour and might be forced to spend valuable time on damage control and remedial action and may even encounter regulatory impediments to expansion.

How to manage regulatory risks?

In India, over the past few years, regulatory changes have changed the environment in which we work and perhaps because the insurance industry is still in its evolving stage, it appears that more changes might be on the horizon. All this demands an intelligent response to managing regulatory risks and we believe and suggest the following proactive approach to managing regulatory risks:

1. **Adopt best practices before they are mandated**:

   The first step for insurers to managing regulatory risk is acquaint themselves with the best practices around the globe and adopt them for the benefits of the customer and ultimately for their own benefit. This solves the double purpose of pre-empting regulation before it arises and also of denying the regulator a reason to introduce it in first place.

   To elaborate, if the best practices are already being followed in the market, the regulator may find no reason to come out with a regulation. But even if the regulator comes out with some change in regulation, it may not cause much concern to the insurer who is already following best practices. This is primarily because the regulations, at least in developing economies like India, are usually based on the experience and best practices prevalent in some of the more developed economies.

2. **Maintain regular communications with domestic and international regulators and keep yourself abreast with latest developments around the world**.

   Maintaining regular communications with the regulator helps to ensure that regulators are familiar with the realities of the business world. It also helps to reassure the regulator that management is on top of issues that might otherwise require regulation.

   But most importantly, regular communications with the regulator may help to gain some prior knowledge of the expected change/introduction and timing of change/introduction of some regulation. This information can then be utilized to plan out the manner to deal with the regulatory change such that its cost implications are minimised and the company's scare resources are optimally utilized.

To consider the usage of above approach, we may consider the example to Risk Based Capital. We all know that some time in (near and not far) future, the Indian insurance industry will move from a simple formula based approach to a Risk Based Capital (RBC) approach. Once the RBC is introduced, or the process for transition to RBC formally starts, the regulations will require insurers to quantify all major risks like underwriting risks, pure market risk, credit risk, asset – liability management risks, so on and so forth. So a proactive approach to this future regulatory change would suggest that insurers actively start working on the road map to implementing RBC. Only those insurers, who have done some prior groundwork in form of analyzing techniques of quantifying risks etc will be able to manage the transition smoothly and in a cost – effective manner, without causing much disruption to its routine business activities.

Conclusion – to regulatory risk management

To conclude on the regulatory risk management, we again wish to reiterate that because Indian insurance industry is still in the phase of evolution and development, we should expect few regulatory changes some time down the line and only a proactive approach can best help to avert the disruption caused by a regulatory change where it arises.

Reputation Risk Management

The area of risk management has seen a lot of research and studies over the past and it continues to do so. But it is interesting to note that while most of the research has been focused towards managing risks that are more quantifiable like investment risks, risks of loss of property etc, some of the important but unquantifiable risks have gone unnoticed. One such risk is the reputational risk which continues to be one of the more elusive risks because of the difficulty in measuring it as well as a lack of understanding of the mechanisms that generate this risk.

Reputational risk has a particularly interesting story in the world of financial services especially insurance industry. This is primarily because while nobody disputes the importance of maintaining good reputation in the market and mitigating reputational risks and while a lot of the research, studies and resources are directed towards defining, measuring, and mitigating the financial risks, nothing is formally done to manage reputation risks. Reputational risk and its management often skate undefined through discussions of risk management at financial institutions. But as risk management is maturing and developing, reputation risk management is gripping the imagination of many top managers.

Reputational risk management is concerned with protecting organisation’s reputation, arguably the organisation's most valuable asset. Reputation risk arises when there is a situation, event or series of events that have the potential to negatively influence public opinion and the perceptions of other stakeholders. This risk may expose the organisation to litigation, financial loss, or a decline in its customer base.

Is reputational risk manageable?

While we agree that reputation is all about public perception, which an organisation may not be able to completely control but surely a lot can be done to influence it. And this is where the role of building trust through being ethical, ensuring efficient communication and building long-term solid relationships inside and outside the organisation comes into picture.

Quantification of Reputation Risk

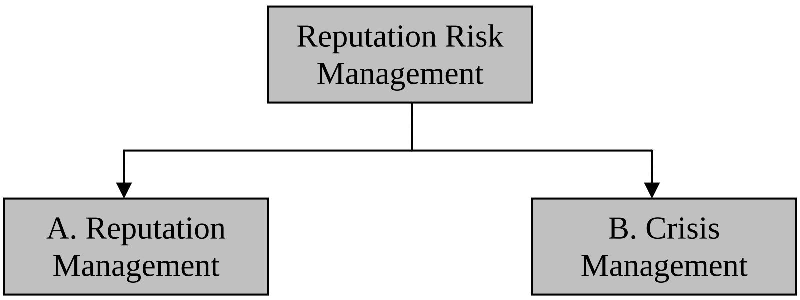
As reputation is an intangible phenomenon relating to perception, there are no straight measures to measuring reputation risk. However, some indirect approaches to examining the reputational impact of losses have been suggested. Most widely known approach measures reputational losses by examining the fall in a company’s market capitalization to the announcement of a major loss event. Any decline in a firm’s market capitalisation that exceeds the announced loss amount is interpreted as a reputational loss. For example, if a company has announced a loss of, say Rs. 100 crores but the market capitalization of its shares has fallen by Rs. 250 crores following the announcement of loss, we may say that Rs. 150 crores is the amount of reputation lost.

But this method also has its own limitations. It is very vulnerable to over – reactions and under – reactions to news announcements in the stock markets. Also, it gives us a figure only after the loss has been incurred and not beforehand i.e. it does not provide us with the amount of reputation at stake.

Though there have been some other attempts made as well towards quantifying reputation risks, we believe that there can be no precise measure of reputation risk.

Reputational Risk and Life Insurance

In an industry like insurance industry where trust and confidence are understood to be key business drivers it is important to realize that reputation is a key source of competitive advantage. For any insurance company, the market value comes from hard – to – assess intangible assets which make these organizations especially susceptible to anything that damages their reputation. For such organisations, the Reputation Risk Management must be a combination of two things, as shown in the figure below:



A. Reputation Management:

Corporate reputations are rarely examined until after they have been damaged and that is a big mistake. Instead of being reactive, one should be proactive. That is why we feel that the best way to reputation management would be the approach where an organisation **slowly builds its reputation** (remember - reputation cannot be built overnight!) **and simultaneously takes active steps to preserve it** (realize – reputation can be easily lost overnight!).

<u>Building reputation</u> revolves around conducting every business or transaction in the most ethical manner. For example, every time an insurance company sells a policy, processes a claim, enters into a contract, builds a new facility, or enters into litigation, it is making decisions that define its reputation. This reputation affects its ability to acquire new clients or even continue servicing existing relationships. Thus, it is essential that it conducts its every transaction in a very professional and efficient way, in compliance with its core values & business ethics and ensuring enough focus on customer centricity i.e. delivering value to the customer. Also, apart from the business, every enterprise has some social responsibilities which it must discharge.

Here are some of the few examples of what an insurer can do to manage its reputational risk:

- Curbing any mis-selling practices carried out by its agents/ advisors and insisting on informed sales.
- Delivering all promised services to the policyholders.

- Maintaining timely and efficient communications among policyholders, regulator and other stakeholders.
- Establishing strong enterprise risk management policies and procedures throughout the organization.
- Instilling ethics throughout the organization by enforcing a code of conduct for the board, management, and staff.
- Complying with current laws and regulations and enforcing existing policies and procedures.
- Responding promptly and accurately to queries by policyholders and the regulator.
- Establishing a crisis management team to carry out tasks (as mentioned below) in the event there is a significant action that may trigger a negative impact on the organization

Preserving reputation revolves around effectively communicating and building solid relationships. For example, communication between an insurer and its stakeholders can be the foundation for a strong reputation. Timely and accurate financial reports, informative newsletters, and excellent customer service are important tools for reinforcing an insurer's credibility and obtaining the trust of its policyholders and other stakeholders.

B. Crisis Management:

There might be circumstances where inspite of dedicated efforts towards reputation management as mentioned above, an organisation may face serious threats to its reputation. So we suggest that an organisation continuously does the following:

1. Continuous assessment of threats to reputation:

As opposed to the process of patiently building trust, a reputation can be ruined overnight by an ill-managed event which results in a crisis. The challenge is that such perils and threats to reputation can come from any direction. Some examples of threats to reputation for life insurance companies in India include:

- the prevalence of mis-selling. We believe that this indeed is the biggest reputational risk facing life insurance companies in India. One big reason for this is the lack of insurance knowledge amongst Indian consumers, which is easily exploited by agents and intermediaries to serve their personal motives.
- failing to deliver promised standards of service and product quality to customers;
- failures to meet regulatory or legal obligations.

So there is a need for the organisations to continuously assess any threats to reputation that arise during the course of business. May be the best way to identify current and potential threats is to have one dedicated responsibility center created to oversee reputational risks and periodically communicate findings to top management and the board.

2. Analyse the potential impact of the threats and prepare action plans:

The next step is to analyse qualitatively and quantitatively (to the extent possible) the implications and seriousness of the threats to business reputation. This is done primarily done to prioritize in circumstances where handling all current/potential threats simultaneously may not be possible.

Thereafter, an action plan is prepared which detailed sets out the sequential steps (together with time – limits) to mitigate a prospective threat to a company's reputation. Action plans typically include information regarding the team, the coordinator, the timing and budgeting of the effort, and the method of assessing the efficiency of the effort.

3. **Carry out the action plans & monitor changing beliefs:**
   Last step, obviously, is to carefully carry out the action plan prepared above. The execution of action plan should be simultaneously supplemented by interviews and surveys of experts and stakeholders which reveal emerging trends and determines whether priorities are changing. Supplement surveys with focus groups and in-depth interviews to gain deeper understandings of the cause and potential effects.

Conclusion – to reputational risk management

As suggested above as well, building a financial institution's reputation may take years, but it certainly can be damaged or even destroyed very quickly. Particularly for financial services companies like insurance companies, reputational risk arises from many sources and has many dimensions. Thus, given the potential impact of reputation, it is only prudent to manage it very judiciously. Indeed, the value of reputation extends over a long period of time!

About the authors:

Manoj Bhudolia

Manoj completed his graduation B. Sc in 1995 from the Burdwan University, West Bengal. He is a student member of the Institute of Actuaries of India and the Institute of Actuaries, UK.

Manoj is currently working with Aviva Life Insurance in the product development team. He also has experience in the area of sales.

Contact details:
Aviva Life Insurance Company India Ltd.
Aviva Tower, Sector Road,
Sector – 43, opposite DLF golf course,
Gurgaon (Haryana)-122003
Tel (O) - +91 – 124 - 2709053
Mobile- +91 - 9910267727
E-mail- manoj.bhudolia@avivaindia.com

Khushwant Pahwa

Khushwant completed his graduation in B.Com (Hons) from Shaheed Bhagat Singh College, Delhi University, in 2004. He is a student member of the Institute of Actuaries of India, the Institute of Actuaries (UK) and the Institute of Chartered Accountants of India.

Khushwant is currently working with Aviva Life Insurance in the product development team. He also has experience in risk management reviews and statutory audits.

Contact details:
Aviva Life Insurance Company India Ltd.
Aviva Tower, Sector Road,
Sector – 43, opposite DLF golf course,
Gurgaon (Haryana)-122003
Tel (O) - +91 – 124 - 2709052
Mobile- +91 - 9910267727
E-mail- khushwant.pahwa@avivaindia.com