Case Study: Risk Appetite Frameworks - Canadian Family Assurance Group

Key Learning Objectives

- To establish familiarity with the types of core principles that might underpin a financial institution's risk appetite framework
- To gain insights into how these core principles can be applied in practice
- To explore the role of the risk appetite framework to help navigate through potential risk/reward trade-offs and establish a clear "tone from the top" for disciplined risk taking behaviour

Background

Canadian Family Assurance Group ("Canadian Family") is a publicly listed (TSX: CFA) Canadian property and casualty insurance group. It has two primary Business Units – the Retail BU and the Commercial BU. The Retail BU offers a wide range of simplified issue retail insurance products (primarily home, auto and travel insurance) to "self-directed" Canadian consumers, with a particular focus on serving the needs of families in the broad middle market. It distributes its products through various direct response channels (i.e. no intermediaries) that include internet sales and inbound/outbound telemarketing, supported by industry leading web-based insurance needs analysis tools, an integrated marketing strategy (print media, off-prime time television advertising and sophisticated web-based positioning) and the use of leading edge simplified issue underwriting techniques. The Commercial BU is focused on serving the commercial property and casualty insurance needs of Canadian entrepreneurs and small businesses, with a particular focus on the commercial real estate, tech and professional services sectors. These products are distributed through a national network of independent insurance brokers. While Canadian Family is licensed in all provinces, it only recently expanded into Western Canada, which currently only accounts for 10% of its total revenue.

Canadian Family's success in developing these capabilities has been supported by its long standing tradition of continuous innovation, data driven decision making and high levels of organizational agility in pursuing emerging opportunities.

While Canadian Family enjoys a long history of overall underwriting profitability, over the last three years ROEs have been in the range of 8-10%, somewhat below its stated long term objective of 13-15% (a level it had historically been able to achieve in the period before the financial crisis). The recently tabled draft Business Plan shows projected profitability largely in line with current ranges, with relatively modest core income and revenue growth (low single digits). The Board has expressed its dissatisfaction with the draft Plan and has challenged management to *"go back and find some creative ways to bring profitability more in line with our long term objectives".*

Canada Family's capital and surplus position is strong and its regulatory capital ratio stands at 340% (3.4 times minimum regulatory requirements), which exceeds its long term "target" level of 235%. The ROE "drag" associate with the current "excess" surplus position accounts for approximately half of the prevailing ROE shortfall.

Canadian Family's stock has traditionally been favoured by income oriented investors, primarily due to its reliable dividend performance. There are currently seven equity analysts rating the stock, with the following ratings distribution: 2 "sell", 4 "hold", 1 "buy". The two "sell" ratings are relatively recent developments, and appear to be based on the recent period of sector underperformance and increasing concerns about future growth prospects.

Canadian Family's articulated corporate vision, mission and values are as follows;

Vision: To be the most trusted provider of insurance solutions to Canadian families and small businesses.
Mission: To help our customers establish control and peace of mind regarding life's inherent uncertainties.

Corporate Values:

- Innovation
- Customer Solution Focus
- Integrity
- Agility
- Data driven decision making

Scenario

A national reinsurance broker recently approached Canadian Family with an opportunity to participate (as part of a reinsurance syndicate) in providing catastrophic loss coverage for certain pools of commercial property insurance risks in Western Canada (i.e. covering aggregate commercial property damage losses above very high deductibles, up to a specified policy limit. The high deductible structure means that any potential claims would only arise as a result of a significant natural catastrophe). The supply of this type of capacity has contracted considerably over the last few years and the current hard market conditions therefore now appear to provide an opportunity to achieve pricing margins significantly in excess of traditional market levels. The broker has indicated a high degree of confidence in being able to place a bid yielding pro-forma ROE's in the mid-20% range. This indicative return has been validated by external actuarial advisors, who Canadian Family retained to assist in the assessment of this opportunity.

While acknowledging that this opportunity may be *"little off of our core strategy"*, both the CEO and head of the Commercial BU support advancing this bid on the basis of the attractive indicative returns, its ability to quickly deploy excess capital and bolster top line growth, and it being a *"great diversification play"* . The CRO has indicated that based on the analysis provided by the reinsurance broker and the retained actuarial advisors, she could *"get comfortable"* with this risk, provided that the transaction is maintained within a prescribed limit and monitored closely. The New Initiatives Policy requires that any capital allocations to new business or underwriting ventures need to be presented to the Risk Committee of the Board for review and approval, hence the reason it is being table on today's agenda.

You are a member of the board Risk Committee being asked to consider this proposed transaction. This discussion has already exceeded the allotted time, with many strong views being expressed both for and against this proposal. Feeling that the Committee is struggling to reach a clear consensus, the Chair pronounced *"This is an interesting opportunity, and we've heard a number of good points being expressed on both sides, but we seem to be spinning our wheels. I don't feel that we've organized our thoughts sufficiently yet to take this to a vote. You know, we recently spent a lot of time and effort developing our Risk Appetite Principles and I know we were all pretty happy with the results. It seems to me that this type of situation is precisely why we need to have a good articulation of our risk appetite. I'd like to suggest that we organize our discussion around those core principles and then take this to a vote once we have the benefit of that holistic perspective in front of us".*