

## Enterprise Risk Management: Insurance Ratings

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Financial Services Ratings

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### What Is the Difference Between Risk Management and ERM?

An **ERM** Program comprehensively applies Risk Management...

- Across **ALL** of the significant risks of the Enterprise
- **Consistently** across the risks
- Consistently with the **fundamental objectives** of the enterprise

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## Full Benefits of an ERM Program

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### In addition, an ERM Program will...

- Develop and maintain systems to periodically measure the capital needed to support the retained risks of the company
- Reflect the risk capital in:
  - Strategic decision making,
  - Product design and pricing,
  - Strategic and tactical investment selection
  - Financial performance evaluation

***The product of a fully-realized ERM Program is  
the optimization of enterprise risk adjusted return***

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## Standard & Poor's Objective

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**Risk management is at the heart of what Standard & Poor's does. Standard & Poor's assesses insurers' risks and how risks are managed.**

***Objective: Enhance ratings by increasing our analytical focus on insurers' risk management practices***

- Previously, only qualitative credit given to risk management practices and models
- Ultimately, may give some quantitative recognition to risk models, but only where models are robust and underlying risk management framework is sound

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## Developing A Framework To Systemically Evaluate ERM

### General S&P ERM Plan:

- A framework to systematically evaluate firms' ERM practices to incorporate into ratings
  - A more systematic input into the evaluation of an insurer's risk tolerances
  - Focusing on the specific risks of each insurer
- These conclusions are incorporated as our ERM category of analysis
- The ERM evaluation becomes 8th section of our full ratings review

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## ERM & Ratings

### ERM Quality Evaluation is based on the risks of the company

#### Importance of ERM in the company rating is based on:

- Capacity to absorb losses
  - Complexity of risks
- 
- A insurer with tight capital and complex risks
    - ERM is very important
  - A insurer with excess capital and ordinary risks
    - ERM is not as important



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## ERM Evaluation – Focus

		Significance of Risk			
		Low	-----	-----	High
Quality of Risk Controls	Low				
	-----				
	-----				
	High				

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## ERM Evaluation Components



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## Risk Management Culture

### **Standard & Poor's Ratings Criteria:**

- Staffing and organizational structure of risk-management function
- Governance structure suggests high degree of influence on decision-making by risk-management staff
- Communication of risk and risk management
- Clear Risk Tolerances tied to Risk Limits

**Risk and risk management are considerations in everyday corporate decision-making**

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## Risk Control Processes

### **Primary Components:**

- Identify Risks
- Evaluate/Quantity/Measures Risk
- Monitor Risks
- Diversity Risks
- Limit, Avoid Risks and Offset Risks
- Exploit Retained Risks
- Transfer Risks
- New Product Risk and Risk Control Review

**Objective: To keep risks & losses to within Insurer Risk Tolerance**

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## Risk Control Applies to:



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## Emerging Risk Management

### Primary Components:

- **Environmental Scanning**
  - To provide advance signals of potential Crisis developments
- **Process for Anticipating Emerging Risks**
  - Development of Emerging Risk Scenarios
- **Process for Envisioning Significance of Emerging Risks**
  - Stress Testing & Liquidity Risk Analysis
- **Process for Preparing Response to Emerging Risk Solutions**
  - Contingency Planning
- **Execution of Company in Emerging Risk Solutions**
  - Changes to company business and risk management practices
- **Company learning process from Emerging Risk Situation**

**Objective: To anticipate the next big risk**

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## Risk and Economic Capital Models

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### Primary Components:

- Type of Risks Modeled
- Modeling methodologies used for each risk
- Modeling of Risk mitigation
- Risk dependencies and aggregation
- Risk measures
- Assumptions
- Data feeding
- Model integrity
- Validation and Documentation

**Objective: To Provide the information on Insurer Risks to Support other ERM Processes**

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## Strategic Risk Management

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### Standard & Poor's Ratings Criteria:

- Consistent view across all risks
- Capability to assess trade-offs between different risk types
- Assessment of risk adjusted returns
- Capital budgeting
- Strategic investment allocation

**Objective: To Optimize Risk-adjusted Returns**

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## ERM Quality Classifications

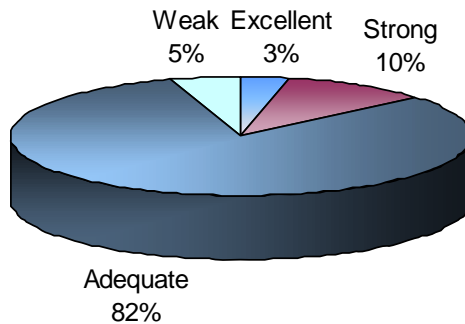
<b>Excellent</b>	<ul style="list-style-type: none"> <li>▪ Advanced capabilities to identify, measure, manage all risk exposures within tolerances</li> <li>▪ Advanced implementation, development and execution of ERM parameters</li> <li>▪ Consistently optimizes risk adjusted returns throughout the organization</li> </ul>
<b>Strong</b>	<ul style="list-style-type: none"> <li>▪ Clear vision of risk tolerance and overall risk profile</li> <li>▪ Risk Control exceeds adequate for most major risks</li> <li>▪ Has robust processes to identify and prepare for emerging risks</li> <li>▪ Incorporates risk management and decision making to optimize risk adjusted returns</li> </ul>
<b>Adequate</b>	<ul style="list-style-type: none"> <li>▪ Has fully functioning control systems in place for all of their major risks</li> <li>▪ May lack a robust process for identifying and preparing for emerging risks</li> <li>▪ Performing good classical "silo" based risk management</li> <li>▪ Not fully developed process to optimize risk adjusted returns</li> </ul>
<b>Weak</b>	<ul style="list-style-type: none"> <li>▪ Incomplete control process for one or more major risks</li> <li>▪ Inconsistent or limited capabilities to identify, measure or manage major risk exposures</li> </ul>

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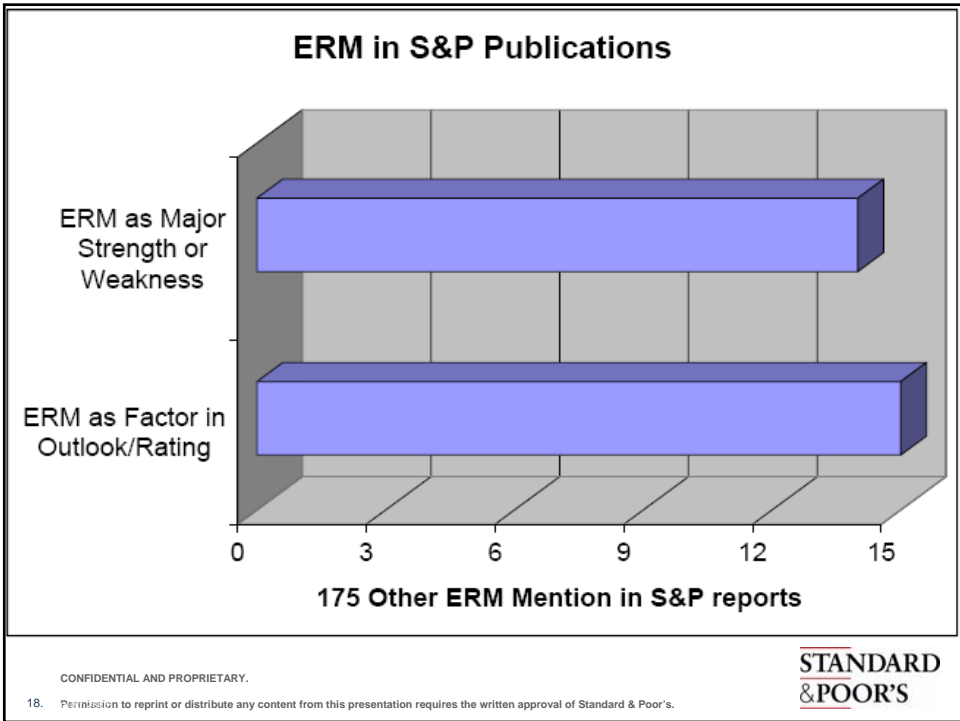
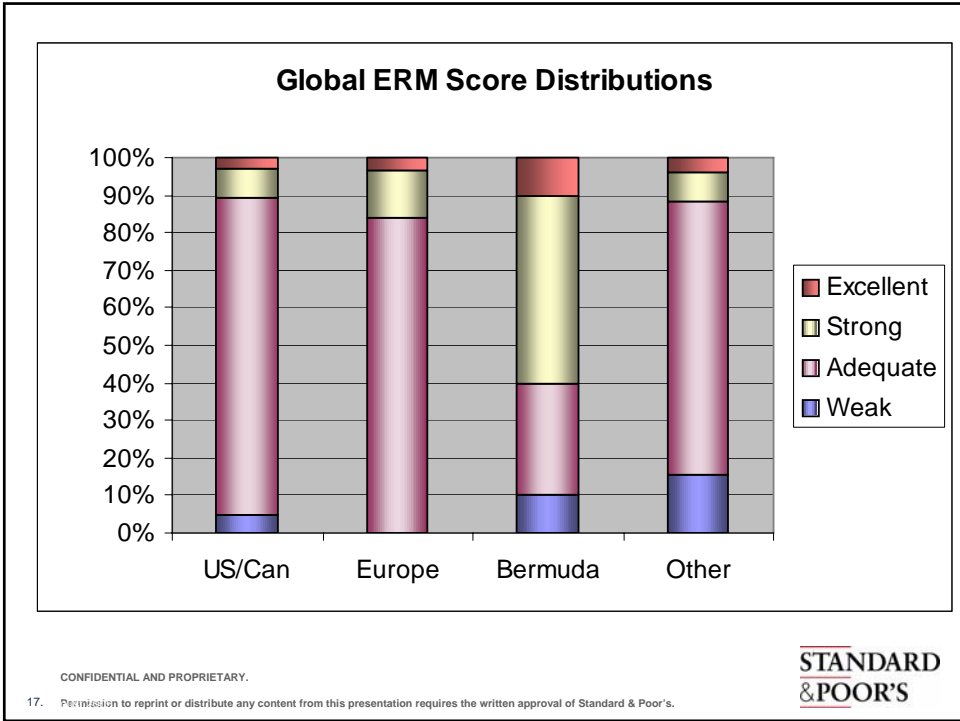
### 2006 All ERM Scores Global 241 Insurers



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## Summary Of Recent Enhancements To Insurer ERM Criteria

<b>Risk Management Culture</b>	<ul style="list-style-type: none"> <li>▪ Additional detail regarding risk tolerance and risk preferences</li> <li>▪ risk limits tied to risk tolerances</li> </ul>
<b>Risk Control Processes</b>	<ul style="list-style-type: none"> <li>▪ A more detailed review of various sound practices for risk control processes</li> <li>▪ The review process will be tailored to individual companies</li> <li>▪ Specific, detailed examples requested for key risks</li> </ul>
<b>Emerging Risks Management</b>	<ul style="list-style-type: none"> <li>▪ Renamed to clarify our focus on <b>new risks</b> that could emerge</li> </ul>
<b>Risk and Economic Capital Models</b>	<ul style="list-style-type: none"> <li>▪ detailed ERM review of models</li> <li>▪ This review will not include validation of the specific output from an Economic Capital model</li> </ul>
<b>Strategic Risk Management</b>	<ul style="list-style-type: none"> <li>▪ Further distinction among common practices that are viewed as weak, adequate, strong or excellent</li> </ul>

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## Economic Capital Review

For Insurers with **Strong or Excellent ERM**

- Standard & Poor's will develop robust processes for evaluating insurers' internal economic capital models
- To be performed only for companies with effective ERM
- Evaluations of economic capital will be used in conjunction with existing static, risk-based measures
- Dynamic approach will enhance our existing and prospective view of capital adequacy

***Standard & Poor's can incorporate benefits of uncorrelated risks (diversification)***

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## Evaluating Economic Capital Models

### Process for Evaluation:

- Framework of assumptions to review
  - For each risk
  - Establish a range for each assumption to be stressed
- Remote events analyzed, using realistic disaster scenario analysis/tail event stress analysis
- Model mechanics reviewed and standardized, where possible
- Testing procedures employed
  - To evaluate the consistency of one firm's model output for a given set of data with that of its peers

*Findings will be incorporated into the companies' ratings*

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## Insurance ERM Key Points

- 1. ERM is a new organizing concept**
  - For looking at a collection of issues we have always covered
- 2. ERM applies to all insurers globally**
- 3. ERM evaluation will be tailored to the risks of each insurer**
- 4. ERM recognizes all the risk management of the insurer**
  - Even if the company does not do “ERM”!!!
- 5. ERM is reflected in insurer ratings**
  - Importance of ERM will vary among companies – just as every other factor does
- 6. ERM is a new section in the ratings report**
- 7. ERM is not a new Capital Model**
  - ERM is not primarily concerned with looking at an insurer's Economic Capital Model



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## Additional Materials

### Insurance ERM Evaluation

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## Risk Control – Investments

### Standard & Poor's Ratings Criteria:

#### Credit Risk

- Traditional Underwriting standard and concentration limits
  - Sell discipline tied to spread monitoring
  - Portfolio Credit Approach supported by Credit VaR Model
  - Credit Derivative use to refine exposures
- << [Look for multiple programs](#) >>

#### Interest Rate Risk

- Monitoring Metrics:
  - Duration, DV01, Convexity
  - Key Rate Durations, Partial Duration
- Look for:
  - Multiple measures,
  - Clear tolerances,
  - Frequent measurement and
  - Frequent rebalancing with
  - Clear practices for violations
  - Attention to minimum guarantees

#### Equity Risk

- Clear idea of the amount of total equity risk from equity holdings, products, pension, etc;
- Look for program for maintaining that total equity risk at a predetermined level
- If hedging risks, look for disciplined program with a sophisticated control structure

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## **Risk Control – Insurance**

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### **Standard & Poor's Ratings Criteria:**

- Underwriting and monitoring processes tied to pre-planned actions for significant deviation from expectations
- Catastrophe modeling and concentration management
- Claims monitoring and management
- Loss reserving discipline
- Reinsurance strategy tied to risk tolerance & consistently utilized
- Underwriting, Claims, Pricing, Reserving closely tied

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## **Risk Control – Operations**

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### **Standard & Poor's Criteria:**

#### **Look for:**

- Significant process to identify and assess Operational Risks and
- Processes to manage risks:
  - Internal Audit
  - Regulatory & Compliance
  - IT
  - Distribution Risk
  - Outsourcing
  - Business Continuity
  - Risks from major new projects and acquisitions

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## ERM Evaluation Process

### General ERM Evaluation

- Part of Management Meeting (1 – 2 hours)
- Preparation of ERM Summary Chart (*Slides following*)
- ERM committee → Rating Committee  
or Direct to Rating Committee
- Written part of Ratings Report
- Verbal feedback to Company from ERM Summary Report

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## ERM Summary Chart – Life

	Opinion	Comments
Overall	Excellent, Strong, Adequate, Weak	Key reason(s) for conclusion
Risks	Credit, Market, Insurance, Operational (or sub risks of those broad categories)	A Summary of the Risk Profile of the company. Discussion of changes to the risk profile over the past several years and how management expects it to change over the next several years. Description of the products or investments that give rise to the major risks.
Earnings Vol / Loss Experience	High, Medium, Low Volatility	Summarize 5 year history of earnings volatility and/or loss experience
Importance of ERM to Rating	Very high, high, moderate, low, very low	Indicate whether this ERM opinion should have high impact on rating. Will be high if company has complex risks and/or tight surplus position. Most Health Insurers have low to moderate risks, but some have low surplus positions which could make ERM of high importance.
Review		
Risk Management Culture	Excellent, Strong, Adequate, Weak	<ul style="list-style-type: none"> <li>▪ The degree to which risk and risk management are important considerations in the every day aspects of corporate decision-making.</li> <li>▪ The staffing and organizational structure of the people who are charged with executing the risk-management function in the insurer.</li> <li>▪ The risk management governance structure that is indicative of a high degree of influence on decision-making by risk-management staff.</li> <li>▪ Communication of risk and risk management—both inside and outside of the insurer — An insurer with a strong risk-management culture will have a very transparent risk-management process within the company and with other interested parties through their public communications.</li> </ul>

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## ERM Summary Chart – Life

Risk Controls – Credit	Excellent, Strong, Adequate, Weak	Types of Credit Risk Management Programs: a) Traditional Underwriting standards and concentrations limits b) Sell discipline tied to spread monitoring c) Portfolio Credit Approach supported by Credit VaR model d) Credit Derivative use to refine exposures Best companies have multiple programs. Standard & Poor's will look at quality of program and effectiveness of execution.
Risk Controls – Interest	Excellent, Strong, Adequate, Weak	Types of Interest Risk Monitoring Metrics: a) Duration, DV01 b) Convexity c) Key Rate Duration, Partial Duration Best companies will use multiple measures, clear tolerances, frequent measurement and frequent rebalancing with clear practices for violations. Standard & Poor's will also look for attention to minimum guarantees.
Risk Controls – Equity	Excellent, Strong, Adequate, Weak	Looking for company to have a clear idea of the amount of risk that they are taking as a result of their equity market exposures and a program for maintaining that risk at a predetermined level. If they are hedging risks, Standard & Poor's will look for disciplined program with a sophisticated control structure.
Risk Controls – Insurance	Excellent, Strong, Adequate, Weak	Standard & Poor's is looking for robust underwriting and monitoring processes that are tied to pre-planned actions for significant deviation from expectations.
Risk Controls – New Product	Excellent, Strong, Adequate, Weak	Formal process of identifying and planning for the changes to the insurer's risk profile due to the introduction of a new product, coverage or investment program. Standard & Poor's will especially look for a product development process that allows meaningful impact of risk analysis on the product.

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Extreme Events & Emerging Risk Mgt	Excellent, Strong, Adequate, Weak	Insurers quality of processes to imagine, assess, prepare for and monitor future risks that are not currently a part of the everyday risk control processes. Might include, but is definitely not limited to Cat reinsurance.
Risk Models	Excellent, Strong, Adequate, Weak	Standard & Poor's will look for an insurer to have capabilities to assess their risk positions with measurement systems that provide timely and actionable information.
Strategic Risk Management	Excellent, Strong, Adequate, Weak	The ability and practice to look across the insurers diverse risks to make decisions about optimizing their risk adjusted returns. This requires both the capability to assess trade-offs between different risk types and an assessment of risk adjusted returns. Would include capital budgeting and strategic investment allocation.
Outlook	Positive, negative, neutral	Many companies will have positive outlook for ERM due to developing nature of ERM

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## ERM Summary Chart – P&C

	Opinion	Comments
Overall	Excellent, Strong, Adequate, Weak	Key reason(s) for conclusion
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## ERM Summary Chart – P&C

Risk Controls – Investment	Excellent, Strong, Adequate, Weak	<p>Clear Credit Risk Standards that are monitored and enforced.</p> <p>Target for matching Asset and Liability Durations with monitoring and enforcement.</p> <p>Clear standards for asset allocation, with set limits diversification and investment style with tracking and enforcement procedures when limits are breached</p> <p>Measurement of risk from investments that reflects the company's actual investment activities with management and board awareness of the level of and changes in investment risk.</p> <p>Counterparty credit risk on reinsurers: acceptance criteria, limits, assignment by line of business.</p>
Risk Controls – Insurance Underwriting	Excellent, Strong, Adequate, Weak	<p>Underwriting Process – Set, monitor and enforce standards</p> <p>Underwriting guidelines – clear documented and enforced standards, which should define delegation of authority, treatment of special lines, escalation and referral procedures.</p> <ul style="list-style-type: none"> <li>* Risk review – Process to ensure risks are reviewed by (experienced and qualified) personnel from relevant practices</li> <li>* Pricing – Process to develop appropriate theoretical price and monitor, limit and enforce deviations.</li> <li>* Process for recording and sharing of pricing information</li> <li>* Cycle Management – Process to identify weak cycle. Planned response and execution in soft market</li> <li>* Claims – process for assessing claims experience and comparing to pricing expectations</li> <li>* Monitoring and feedback mechanism – Underwriting, Pricing and Claims</li> </ul>

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## ERM Summary Chart – P&C

Risk Controls – Catastrophe Risk	Excellent, Strong, Adequate, Weak	<ul style="list-style-type: none"> <li>* Exposure concentration limits, monitoring and enforcement process</li> <li>* Model to advise setting concentration limits and to price</li> <li>* Process to set and update model assumptions</li> <li>* Process to feedback strengths, weaknesses and assumptions underlying models</li> </ul>
Risk Controls – Reinsurance	Excellent, Strong, Adequate, Weak	<ul style="list-style-type: none"> <li>* Process to assess reinsurance needs: Is it price/capacity based or does it have economic capital considerations?</li> <li>* Process to monitor and enforce compliance with policy</li> <li>* Process to update reinsurance program as conditions change</li> <li>* Process for optimizing risk-return trade-off</li> </ul>
Risk Control – Reserve Risk	Excellent, Strong, Adequate, Weak	<ul style="list-style-type: none"> <li>* Processes for dealing with: <ul style="list-style-type: none"> <li>* Uncertainty</li> <li>* Data quality and volume</li> <li>* Emerging changes in development</li> <li>* Changes in legal environment</li> <li>* Changes in claims environment</li> <li>* Changes in underwriting and claims management processes</li> <li>* Reserving across the cycle(s)</li> <li>* Large and disputed claims</li> <li>* Process for giving feedback to Pricing &amp; Underwriting processes</li> </ul> </li> </ul>
Risk Controls – New Product	Excellent, Strong, Adequate, Weak	Formal process of identifying and planning for the changes to the insurer's risk profile due to the introduction of a new product, coverage or investment program. Standard & Poor's will especially look for a product development process that allows meaningful impact of risk analysis on the product. Assessment of group wide accumulation before product approval

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## ERM Summary Chart – P&C

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## Enterprise Risk Management: Insurance Ratings

Insurance ERM Evaluation Criteria on the web at  
[www.erm.standardandpoors.com](http://www.erm.standardandpoors.com)

For further Information Contact:  
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