

Market update – ERM in Insurance

ERM Symposium Workshop

March 28, 2007

Michael J. Belfatti, FCAS, MAAA
North America Property-Casualty ERM Practice Leader

ERM in the Property-Casualty insurance sector

Agenda

- Rating agency developments
- Company perspectives and activities
- ERM in strategic decisions
- On the horizon...
- ERM questions

Rating agency developments

Framework updates

- AM Best draft ERM framework
- S&P economic capital model review framework
- Controls and portfolio risk awareness > capital modeling at this stage

Priorities / Context-Appropriate ERM

- Rating agency focus is on prioritizing – companies understand this importance
 - Regional vs. Global
 - Life vs. PC vs. Both
 - Complexity of operations and products

Ex-Post ERM Failures

- Rating agency focus is identifying potential for problems before they occur
- That said, results are still central – perceived ERM failures will be judged harshly.

Company activities and perspectives

Formalizing processes, documentation, communication

- “We’re already doing ERM” but could use a second look
- Link to Sarbanes-Oxley

Governance, organizational structure

- Most are considering new positions or committees
 - Regional companies more commonly using committee approach
- Some realization that organizational structure is a fundamental element of ERM

Risk identification and appetite exercises

- Asking tough questions – how much is too much (how do we decide?)
- Threat scenario analysis / brainstorming sessions
- Cross-functional
- Not easily modelable does not mean not a big risk – e.g. personal lines distribution

Company activities and perspectives

New data and modeling efforts

- Larger players are making significant investments in technology and data
- Accumulation focus expanding beyond catastrophe modeling
- Central focus on risk-adjusted pricing and performance measurement
- External peer review and prioritization of enhancements
- Intelligent use of modeling is a common topic

Operational risk

- Companies realize the variety of “unintentional” risks – systems, people, reputation
- Many are trying to build some rigor to the identification process
- Quantification efforts are still early but growing
- Key question – how to do better than “closing the barn door”
 - “All risks” controls

ERM in strategic decisions

Cycle Management

- In most lines, market is softening
 - Benign liability conditions including persistent frequency decline
 - Quiet cat season in 2006
 - Calendar year releases where earlier estimates are proving pessimistic

- Company strategic focus
 - Where to get growth
 - What new businesses are complementary
 - When to walk away
 - Property example – direct pricing optimization; reinsurance costs

ERM in strategic decisions

Cycle Management

- Most companies still have significant need for improved leading metrics
 - Early warning
 - Estimate-free (less biased)
 - Belief – enough to make real decisions

- Cycle management decisions fit into a broader theme related to ERM - Risk, capital and value
 - Core expertise and competitive position
 - Objectives, risk tolerances
 - Accumulation management – including pricing error

ERM in strategic decisions

Mergers/Consolidation

- More discussion about merger opportunities
 - Desire for growth; platform expansion
 - Expense efficiencies targeted
 - Fluid Bermuda market – direction of startups; Florida regulatory issues

- ERM is a central discussion point
 - How the portfolios fit together
 - Controls/processes as a way to predict likelihood of future surprises
 - Data needs
 - Price - risk, capital and value

On the horizon...

Continued migration of rating agency role

- Solvency and risk management testing issues are of central importance
 - But limited resources to dig into details

- Current solution
 - Apply consistent but high-level, basic models
 - Advantage of broad applicability, but disadvantage of lack of customization

- Companies will continue to build detailed models and systems to price and track risk
 - These models will have advantage of custom, risk-specific details

- Rating agency role may migrate – Focus on model standards, model and output validation, model integrity, intelligent usage of quantification

On the horizon...

Investor interest

- Risk is the business of an insurance company – understanding your risks is basic business management
 - Economic value is enhanced by rigorous and consistent measures of risk; risk-based pricing and performance measurement is critical
 - Correlation/aggregation is critical – does a company understand how much capital it is putting on the line for various types of risks

- The central challenge of risk management: Using practices/philosophies to infer likely performance, not figuring it out only after events occur
 - This is an inherent focus for investors

- Enterprise performance is important
 - Not individual risks per se

On the horizon...

Investor interest

- Quality of risk and capital management affects
 - Likelihood of stable earnings
 - Likelihood of large surprise losses

- Technology allows competitive advantage
 - Risk analysis, pricing, monitoring, accumulation tracking

- Operational controls also affect likelihood of surprise declines in franchise value
 - Reputational risk
 - System failure
 - Rogue underwriting

ERM questions

- Governance
 - What is your governance structure for ERM?
 - How do the heads of the different functions work together? How are cross-functional threats identified and managed?

- Risk Metrics and Reporting
 - How is risk reporting handled in the organization?
 - What metrics are most closely watched by which functions?
 - What data improvements are planned? How are they prioritized?

- Risk Controls and Limits
 - Do you have limits on types of risk?
 - How are they determined? How do they support the broader vision and strategy?
 - How are violations monitored?
 - What other operational controls exist? How often are the controls themselves reviewed?

ERM questions

- Pricing
 - How do you determine whether the price of a risk is in balance with the amount of risk?
 - How is the current composition of the portfolio reflected in pricing?

- Scenario Analysis
 - How would your overall operation be affected by:
 - The downturn in a given industry
 - The default of a single counterparty
 - A significant regulatory change in a given jurisdiction
 - A gradual, prolonged rise in inflation
 - The operational failure of a key vendor
 - The emergence of a significant new class of liability
 - A terrorism event

- Economic / Environmental modeling
 - Are assets and liabilities calculated using common economic scenarios?
 - Are liabilities sensitive to inflation? How does this affect investment policy?

ERM questions

- Cycle identification and management
 - What metrics are reviewed to determine the state of the market?
 - Are some “estimate-free” metrics utilized?
 - How much business is written using a single model?
 - What are your assumptions regarding business correlation over time? Do you modify your growth plans by how much data is emerging on past years?

- Funding of Risk
 - How do you determine whether reinsurance of a given kind should be purchased? Is reinsurance premium compared to other sources and costs of capital?