

Company and Regulator Best Practices for ERM
State Farm's® View

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AGENDA

- State Farm's® View
- Systemically Important Financial Institution (SIFI) Regulation
- ERM at State Farm®
- NAIC's Solvency Modernization Initiative (SMI) including Own Risk Solvency Assessment (ORSA) Requirements
- Stress Testing's Role in Regulation

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STATE FARM Mutual Automobile Insurance Company® *

- Parent of Affiliates under Illinois Holding Company Act
- 11 active insurance affiliates
- 1 Bank("Thrift")
- 1 Mutual Fund/Investment Company

* Please see Sch Y of Annual Statement for a more complete listing of affiliates.

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Systemic Risk Regulation

Dodd-Frank Act

Dodd-Frank Act creates a systemic risk regulatory system for certain financial services companies, including Non-Bank Financial Companies (NBFCs).

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Systemic Risk Regulation

Dodd-Frank Act Establishes

- FIO (Federal Insurance Office)
- FSOC (Financial Stability Oversight Council)
- CFPB (Consumer Financial Protection Bureau)

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FSOC – Financial Stability Oversight Council

- Organization of FSOC
- Systemically Important Financial Institution (SIFI) Designation - “threat to financial stability of the U.S.”
- Recommended Rules if Systemic Risk

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Systemic Risk Regulation

State Farm’s® views concerning systemic risk regulation are similar to the views found in the responses to the FSOC’s ANPR (Advance Notice of Proposed Rulemaking) from The Property & Casualty Insurers Coalition and NAMIC (National Association of Mutual Insurance Companies).

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**P&C Insurers Coalition
Primary Theme**

NBFCs (Non-bank Financial Companies) providing traditional P&C insurance products do not conduct activities that threaten the financial stability of the U.S. (e.g. activities that are off-balance sheet, unregulated, interconnected, highly leveraged, and subject to “runs-on-the-bank”).

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P&C Insurers Coalition

Second Theme

“the standards for determining systemic risk should consider more than the size or scope of the business, and focus primarily on the kind and character of the activities engaged in and the degree to which they are regulated.”

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P&C Insurers Coalition

Third Theme

“a systemic importance designation should be considered holistically and not mechanically.”

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NAMIC

National Association of Mutual Ins. Companies

Main Street-focused financial firms such as mutual insurance companies . . . have an entirely different mission & business model than Wall Street capital intermediaries. Mutual insurance companies serve different customers & are subject to an entirely different & more rigorous regulatory regime.

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Systemic Risk Regulation
State Farm's® Summary Position

Most traditional insurance companies, State Farm® included, do not pose a threat to U.S. financial stability and, therefore, do not warrant further consideration for systemic risk designation under Section 113 (Dodd-Frank Act).

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ERM at State Farm®
Background

- Major structural change in 2007
- ERM Director & ERM Unit

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Four Best Practices

- Drive toward explicit risk management
- Integrate risk management into the business
- Develop and utilize risk tolerance and appetite
- Employ key risk indicators

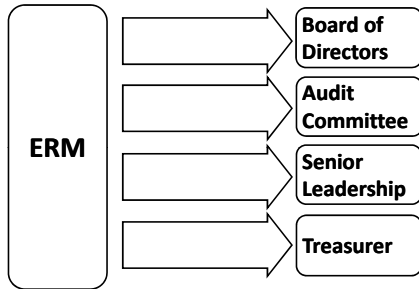
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Drive Toward Explicit RM

- When risk management is ad hoc, informal, and implicit, boards/executives have an incomplete view of top risk exposures (COSO, 2009)
- Regulators and auditors seek “demonstrated” ERM
- Leading practices emerging from crisis include:
 - Transparency
 - Accountability

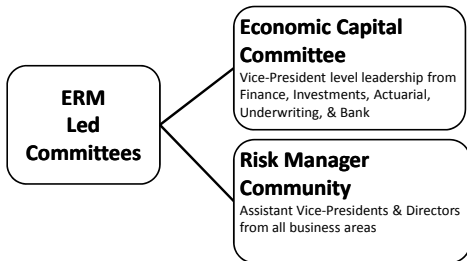
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State Farm® ERM Stakeholders



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State Farm® ERM Committees



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**Integration into the Business:
State Farm® Risk Manager Community**

Comprehensive risk management....

- Is not the domain of any one area
- Can NOT be truly "comprehensive" when executed within silos
- Means integrated risk management efforts
- Requires that managers across the enterprise have the training/tools to identify, manage, and control risks as they conduct business

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NAIC's Plans for ERM Requirements

Context and Background

- Part of overall SMI effort
- Reaction to IAIS – ICP 16 (International Association of Insurance Supervisors-Insurance Core Principle 16)
- Reaction to EU's Solvency II ORSA
- FSAP (Financial Sector Assessment Program) review of US Solvency Regulation

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Own Risk and Solvency Assessment (ORSA) Requirement

- Expectation for Model Law or Regulation
- Charge Board of Directors and/or Senior Management with conducting an ORSA annually and reporting the results to the state regulator
- Confidentiality will be part of Model Law and be similar to insurance examination statutes
- Desire to ensure companies have developed an ERM policy
- Expectation that it will lead to better allocation of regulatory resources for risk focused exams

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Own Risk and Solvency Assessment (ORSA) Requirement

NAIC Proposal released for comment 2/14/11

- Section 1 – Description of Risk Mgmt Policy
- Section 2 – Quantitative Measurement of risk Exposures in Normal and Stressed Environments
- Section 3 – Prospective Solvency Assessments

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Section 1 – Risk Mgmt Policy

- **Shall** document in **complete detail** the company's risk management policy
- Identify **all relevant and material** risk categories
- Describe how those risk categories are **managed on a day to day basis**
- Describe **monitoring** processes
- Include **risk tolerance statements** and **relationship to capital** (regulatory and economic)

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Section I – Continued

The Risk Management Policy shall include:

- Investment policy
- Underwriting policy/pricing/product design
- Claims processing policies – coverage confirmation
- Anti-fraud policies
- Asset – liability management
- Retention or conservation policy
- Reinsurance counterparty policy
- Group membership risk
- Disclosure of how the policy is used in day to day operations and business strategy, tolerance limits, feedback loops and how it's related to capital

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Section 2 – Quantitative Measures

- Document **quantitative measurements** for each risk exposure under normal and stressed conditions
- Use a range of outcomes using techniques that are appropriate for the **nature, scale and complexity** of risks
- Include **detailed descriptions** and explanations of the risk, measurement approaches, assumptions and outcomes of any plausible adverse scenarios
- **Examples** – credit, market, liquidity, cash flow mismatch, underwriting, claim, expense, operational and risks of group membership

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Section 2 – Quantitative Measures

(continued)

- Because risk profiles of companies are unique, **no standard set** of stress conditions will be required.
- **Regulator may provide suggestions** for stress scenarios.
- Examples include **Notional Amount**, Expected Value – Normal, Expected Value - Stressed, Reverse Stress Test Factor for each risk category.
- Difficulty in determining the **relationship between risk categories**.

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Section 3 – Prospective Risk Assessment

- Document how the company combines qualitative elements with quantitative measures to determine needed capital over the longer term business cycle
- Demonstrate the company has the financial resources needed given capital requirements (regulatory and economic), the quality of capital, the risk tolerance limits, current risk exposures (normal and stressed), over a projected 3-5 year business plan
- If not, describe management actions to address deficiencies

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ORSA - State Farm's®
Questions, Concerns, & Issues

- Confidentiality
- Group vs. individual company assessment
- Volume of information requested.
- Appears to be overly prescriptive

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ORSA - State Farm's®
Questions, Concerns, & Issues (Continued)

- Crosses the line between management and regulator
- Proportionality is needed
- How should risk correlation be measured and reported?

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ORSA - State Farm's®
Questions, Concerns, & Issues (Continued)

- Should avoid additional work that has no internal value to the company
- Incorporate requirement into Risk Focused Examination process
- Consider significantly reduced interim reporting

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ORSA - State Farm's®
Questions, Concerns, & Issues (Continued)

- Avoid pricing & cost of capital issues
- Where does it stop within a holding company group?
- Regulator expertise to evaluate ERM programs may be insufficient

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**NAIC's ORSA Proposal - Exposed for
Comments Until 3/18**

Proposal can be found on NAIC's website:
http://www.naic.org/documents/committees_isftf_exposures_orisa.pdf

Industry input is being requested and several meetings are being planned to discuss comments received.

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**State Farm's® View
Stress Testing's Role in Regulation**

- Risk-based capital principles
 - Risk focused
 - Flexible
 - Consistently applied
 - Transparent
 - Cost effective
 - Relatively easy to use and understand
 - Difficult to manipulate

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State Farm's® View
Stress Testing's Role in Regulation

- Concerns with NAIC ORSA
 - Need to reflect diversity of risk
 - Notional amounts not critical for stress testing
 - Some categories will be difficult to consistently measure – e.g., operational
 - Reverse stress test will not be meaningful for all categories
 - Measurement of stress tests will differ based on company's risk appetite. How will this help regulators?

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State Farm's® View
Stress Testing

- Continually review scenarios
- Consider stand-alone and diversified risk for significant factors
- Stress both sides of the balance sheet
- Consider both static and dynamic stress tests

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