ENTERPRISE RISK MANAGEMENT

# THE BEST OF ERM

**A.M. Best's enterprise risk management (ERM) criteria further confirm ERM as a central tool for insurers to manage their risk, capital and strategic decisions more effectively.**

*By Hubert Mueller, Eric Simpson and Edward Easop*

After many years of gestation, ERM has become part of the fabric of how insurance companies are — and will be — managed. Traditional risk management methods are an important foundation for ERM but a broader, enterprise-wide, view is now required. In a recent white paper, A.M. Best (Best) clarified its own ideas about ERM practices of insurers.

Best notes that changes in the risk management landscape are accelerating due to the convergence of regulatory, rating agency and economic views of capital adequacy. Accordingly, Best has toughened its stance on ERM requirements for insurers, updating its prior paper to reflect the global view that Solvency II developments in Europe will raise the competitive bar for U.S.-based insurers of all sizes. In fact, regulators everywhere are moving to more dynamic "principles-based" regimes that promote greater emphasis on risk management, sound controls and governance, internal capital modeling and transparency.

## FACING MORE EXTREME RISK PROFILES

In part, the greater push for the development of ERM tools and practices stems from an increased awareness that a number of extreme events have exposed insurers to greater risk and uncertainty that are not being addressed effectively through traditional risk management methods.

Hurricanes in the past few years and the September 11, 2001 events brought exposure to extensive losses in a concentrated geographic location and across multiple lines of coverage. Enron, Worldcom and other events illustrated the exposure to counterparty risk, with potential losses on both assets and liabilities. The credit crisis has highlighted insurer asset, liability and capital access exposure to financial market disruptions. The potential for a pandemic reminds companies of the need to prepare for new and emerging risk patterns.

The industry's risk profile has also trended higher as companies have developed more sophisticated and complex products to exploit new market opportunities. In particular, within the retirement savings segment, the aging of the population offers massive growth potential for those insurers able to manage the risks associated with offering products with lifetime income guarantees, combining interest rate, asset/liability matching, disintermediation and longevity risks, as well as risks from policyholder optionality (see *Exhibit 1*).

These trends have inspired the development of new risk management tools, including economic capital models, catastrophe modeling tools and dynamic hedging programs. All of these tools seek to combat the industry's growing exposure to earnings and capital volatility and to give greater consideration to risk events that impact company operations.

## COMPETITORS RAISE THE BAR

Until recently, most U.S.-based insurers have limited their ERM mindset to a defensive approach emphasizing the repackaging of current risk management practices in response to increased rating agency, regulatory and investor scrutiny.

Now, more companies are beginning to view ERM from an "offensive" mindset. Progressive insurers want to better allocate their capital from a strategic risk/reward perspective and gain a competitive advantage by leveraging ERM and economic capital modeling in their strategic decision making. This proactive mindset is well under way with companies in Europe and Bermuda, and is spreading throughout the U.S., especially among companies with a global exposure. As large, complex organizations and progressive regional U.S.-based insurers develop increasingly sophisticated methods to identify, measure and manage risk, the bar will be raised for all.

## RISK MANAGEMENT AND THE RATING PROCESS

While S&P has grabbed many of the rating agency ERM headlines, most insurers still view their A.M. Best rating as the most important U.S. rating. Domestic insurers' interest in ERM will accelerate, given Best's increased scrutiny of risk management practices and the subtle but far-reaching implications that ERM will have for ratings and capital requirements.

It is Best's view that all insurers will need to customize their ERM approach to their risk profile to build sustainable earnings and generate capital, remain competitive and maintain acceptable ratings. Complex insurers — such as those insurers participating in the global reinsurance and retirement savings markets — are expected to fully adopt ERM and demonstrate economic capital modeling in their strategic decision making.

For less complex insurers focusing on stable, traditional lines of business, Best's ERM requirements may be somewhat less

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**EXHIBIT 1**
**Industry risk profile trends**

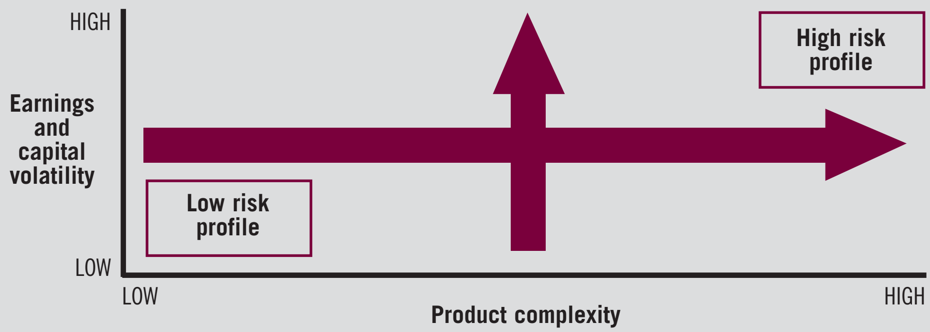
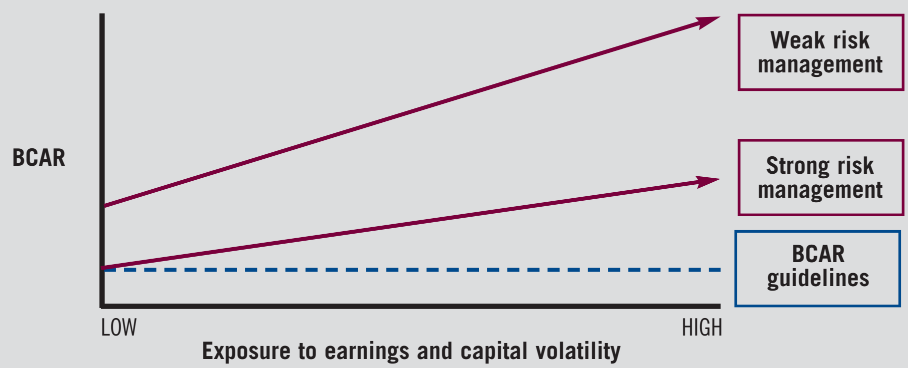



**EXHIBIT 2**
**Risk management and BCAR — A.M. Best's traditional approach**




rigorous — *at present*. However, Best has always scrutinized each insurer's risk management practices, regardless of size and complexity. Currently, Best's enhanced ERM scrutiny will be most pronounced for highly rated insurers (rated A+ and A++) and those seeking rating upgrades.

Best believes that risk management is the common thread that links balance sheet strength, operating performance and business profile. These measures can rarely be separated when evaluating a company and, in particular, its capital, because operating performance and business profile are future indicators of balance sheet strength.

Best is now employing an approach more closely linked to a company's relative ERM strength and earnings volatility. For example, an insurer with a "strong" ERM program and low earnings volatility can usually operate closer to Best's capital adequacy ratio (BCAR) guideline, or published minimums, for its current rating level. Conversely, an insurer deemed to have "weak" ERM and "high" volatility may need to retain more capital (see *Exhibit 2*).

## WHAT'S NEW ABOUT ERM

Best has expanded its view of the risk management evaluation process (see *Exhibit 3* on page 9). The foundation — traditional risk management practices and controls — remains the same. It represents the compilation of practices designed to help insurers monitor and manage their individual exposures to catastrophe, pricing, asset and reserving risks. Capital management, which provides an appropriate backstop to absorb losses not sufficiently mitigated by risk management techniques, remains unchanged.

At the top, senior management continues to make strategic decisions regarding risk and capital. In the past, this decision-making process typically involved little or no interaction and alignment among risk "owners." This silo approach will be viewed by Best as less effective going forward, even for smaller insurers.

Best expects senior management to incorporate selected ERM elements into its risk management framework to take account of risk and capital in a more holistic manner. Best views top ERM practitioners as having well-articulated corporate risk appetite objectives measured through robust risk modeling that assesses various risks on a common metric. Taken together, Best views these elements as providing better information and more sophisticated tools for improved strategic decision making.

Properly employed, ERM allows a company to consider the individual risks at hand, as well as any correlations of risk across the entire organization. Ultimately, Best sees

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ERM as an integral part of risk and business management throughout company operations for two fundamental purposes:

- to manage exposure to potential earnings and capital volatility
- to maximize value to the various stakeholders.

## IMPACT ON BEST'S RATINGS AND BCAR

The importance of ERM to a company's rating will vary based on Best's qualitative and quantitative assessment of four key areas:

- the insurer's complexity
- relative earnings and capital volatility
- financial flexibility
- traditional risk management strength.

Regarding relative volatility, Best will consider factors associated with the company's inherent business profile risks, its earnings and capital trends, and its strategic plan execution. In particular, Best remains keenly focused on companies that have a high degree of natural catastrophe and terrorism risk exposures. In addition, there is particular weight on a company's historic net loss ratio trends (five and 10 year) relative to peers as an indicator of core underwriting competence. Lastly, Best requires insurers to provide their financial projections — both in meetings and in their rating questionnaires (the SRQ) — to gauge if management has a good track record and consistently executes its financial plans.

Each company must establish a program that is appropriate to its risk profile and risk management needs. Best's rating process includes evolving questions and meeting discussions to understand how each company is responding compared with its peers. As a result, insurers need to include ERM discussions in their annual rating meeting and have a clear understanding of the importance of their ERM practices to their rating and capital evaluation.

To provide clarity, elements of a company's ERM practices are beginning to appear in company reports and rating release announcements. Further, Best has taken some tough rating stances with some prominent reinsurers whose ratings have been negatively affected by ERM-related issues, despite strong capital levels. It is likely that these rating trends will increase, particularly as many industry segments experience soft market conditions.

## BEST'S ERM CHECKLIST

While ERM rating meeting discussions will vary, Best has instituted an "ERM Checklist" that its analysts use to organize and present their findings to Best's rating committees in order to facilitate comparisons among peers. That checklist, which is detailed in the appendix to Best's latest white paper, reflects both favorable and unfavorable characteristics of a company's ERM practices in three areas:

- ERM framework and culture
- risk identification and management
- risk measurement and capital modeling.

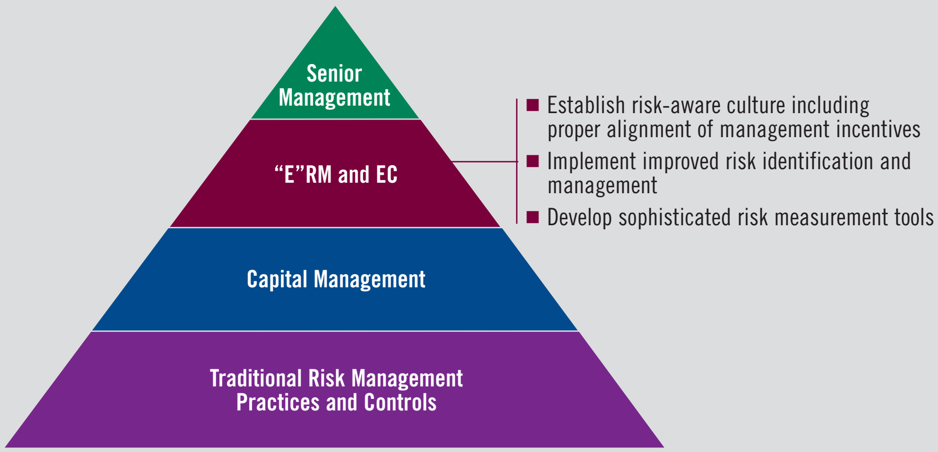
Best actively compares a company's ERM practices in these three areas against characteristics outlined in its white paper. Listed below are many of the best practices that the Best white paper described.

- **ERM Framework and Culture.** An effective risk culture starts at the top with strong support from senior management reinforced by a governance structure that includes board endorsement of the ERM plan and regular oversight of its development. Attitudes toward risk are clearly established through articulation of a risk appetite and risk tolerances that provide the basis for risk controls and risk metrics. Roles and responsibilities must be well established. Risk management is part of the fabric of business plans and reward systems. An individual with chief risk officer responsibilities is expected to manage the process apart from the risk-assuming functions of the business. Business decisions consider risk-adjusted return potential. The system is transparent to help all management and staff contribute to its sound execution.

- **Risk Identification and Management.** Changing risk patterns require a process of constant reassessment, including anticipation of emerging risks. Monitoring and reporting should lead to action when analysis shows risk trends outside risk tolerances, with early warning systems to anticipate adverse results before they can make a significant impact on operating results and the balance sheet.

Risks must be identified, categorized and prioritized within a manageable definitional structure that everyone understands. It is important to understand the various elements, or risk drivers, that create risk of loss (or opportunity for gain) to be able to respond appropriately to adverse trends.

EXHIBIT 3
**Enterprise Risk Management Framework**




This is part of an ongoing monitoring process that uses risk intelligence to shape revisions to strategic positions, e.g., adjusting the mix of business by line, adding or withdrawing a product line, or investing in a new distribution channel. Reinsurance optimization provides needed coverage at a cost covered by pricing and takes advantage of reinsurance market opportunities while maintaining efficient use of capital supporting retentions.

■ **Risk Measurement and Capital Modeling.** Risk appetite and risk tolerances provide the basis for risk metrics that disclose whether risk expectations are being met. Scorecards provide regular feedback to evaluate risk assumption, effectiveness of risk mitigation and efficiency in risk transfer.

Use of "what if" scenario analysis helps to anticipate the likely implications of changes in market conditions and company performance. A rating downgrade, movement in interest rates or a major loss event can change the rules going forward.

Because trends are moving rapidly toward the use of internal capital modeling, it is increasingly falling to companies to manage their risk profile, calculate their capital requirements (beyond tracking their BCAR scores), and demonstrate to regulators and rating agencies that they have strong risk management systems and more accurate risk measurement systems.

This means that all companies need to be on a path of continuous improvement in the quality and sophistication of their capital modeling capabilities. Short term, companies may get by stress-testing some key risk scenarios. Ultimately, it will be the competitive market that will dictate the use of economic capital models with stochastic analysis, evaluating risks in terms of loss probability distributions.

## FUTURE DEVELOPMENTS

Like other rating agencies, Best is not expecting all insurers to have a fully functioning ERM framework and procedures in place immediately. But those organizations deemed complex must have appropriately sophisticated ERM/EC capabilities and processes, as must those rated at the A+/A++ level that wish to retain their rating in the future. And those seeking ratings above A- must be able to demonstrate strong ERM programs that foster sustainable out-performance relative to peers throughout an underwriting cycle.

Best will continue to rely primarily on its BCAR model in assessing insurers' capital adequacy on a consistent basis. Over time, similar to S&P, Best is prepared to permit a minority of top ERM practitioners to maintain BCAR scores below published minimums for their respective rating level. Acceptance will be reserved for these companies if they meet four tests:

- Maintain strong traditional risk management tools for all categories of risk.
- Demonstrate superior capital management and financial flexibility.
- Have established robust ERM programs.
- Maintain strong economic capital capabilities.

Meanwhile, as Best gains experience and exposure to the multitude of company ERM practices, it will be developing and publishing additional ERM criteria, including its criteria related to evaluating insurers' internal capital models.

In the final analysis, all insurers should be actively developing robust ERM programs appropriate for their risk profile to respond to increasing rating agency requirements and competition as well as to support better strategic decisions. Companies that do not embrace ERM run the risk of falling behind in a consolidating marketplace.

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