Trends in ERM

Emerging NAIC ORSA and A.M. Best Requirements

Eric Simpson, Towers Watson
Thomas M. Mount, A.M. Best Company

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ERM discussion outline

- Introduction
- NAIC's Emerging ORSA Requirements
- A.M. Best's Approach to ERM and New SRQ Questions
- Wrap-up
- Q&A

Introduction

Why is ERM ready to take off?

- Unprecedented shock losses in the past decade:
  - Early 2000s: Corporate scandals
  - 2001: September 11 terrorist attacks
  - 2004/5: Record hurricane frequency/severity
  - 2008: Global financial crisis
- Solvency II--shift in solvency measurement from “rules-based” to “principles-based”:
  - Risk management culture and practices
  - Corporate governance frameworks
  - Internal capital modeling tools
  - Increased transparency and disclosure
- Proactive insurers are making continuing improvements:
  - Recognition that fact-based analytics can supplement management instinct
  - More powerful and sophisticated risk measurement tools are becoming available
  - Soft market conditions amplify importance of pricing and reserving discipline
  - The NAIC and rating agencies are increasing their ERM requirements

The NAIC is ramping up its ERM requirements which will have far-reaching implications for US-based insurers

Risk-Focused Exams

- Regulatory assessments of insurer's ERM practices became effective with exams in 2010
  - Key risk evaluations driven by management's assessment/prioritization of current risks
  - Exam focus is shifting from "rear-view" to "prospective-view" on risks
  - Companies need to communicate mitigation strategies for key prospective risks
- Companies exhibiting "weak" ERM may incur increased oversight and compliance costs

NAIC Own Risk and Solvency Assessment Requirement (ORSA)

- Early in 2011, an exposure draft was issued proposing an ORSA requirement
  - Will likely require insurers with >$500M of premium to conduct a periodic ORSA
  - Insurers must demonstrate in-place processes to identify key risks to their strategy
  - Will need to quantitatively show that economic/regulatory capital supports key risks
  - ORSA will likely be aligned with the risk-focused exams
- May require insurers to develop a three-part risk policy document:
  - Description of risk management policy
  - Quantitative measurements of risk exposure in normal and stressed environments
  - Prospective solvency assessment

All insurers will need to stay ahead of A.M. Best's more probing SRQ questions and ERM evaluations in their upcoming meetings

Evaluation Area	A.M. Best's ERM Hot Buttons
Risk Culture	• Board and risk committee are engaged; CRO-type individual is effectively coordinating ERM activity • Well-articulated ERM mission and corporate risk appetite statements • Clear CEO support; risk-aware culture is embedded across the company
Risk Controls	• Top risk accumulations are assessed, prioritized and mitigated within an objective framework • Risk correlations are considered; emerging new risks are identified • Financial projections are stress-tested using deterministic risk scenarios • Dashboard reporting is conducted for key risks, comparing current exposure levels versus maximum risk tolerances
Economic Capital Modeling	• EC modeling is used to quantify aggregate risk • EC model parameters are regularly reviewed and updated • Corporate risk appetite is validated through risk quantification, with consistent metrics to measure and monitor risks across the business • Economic capital modeling is used in strategic decision making and considers risk-adjusted return measures

NAIC's Emerging ORSA Requirements

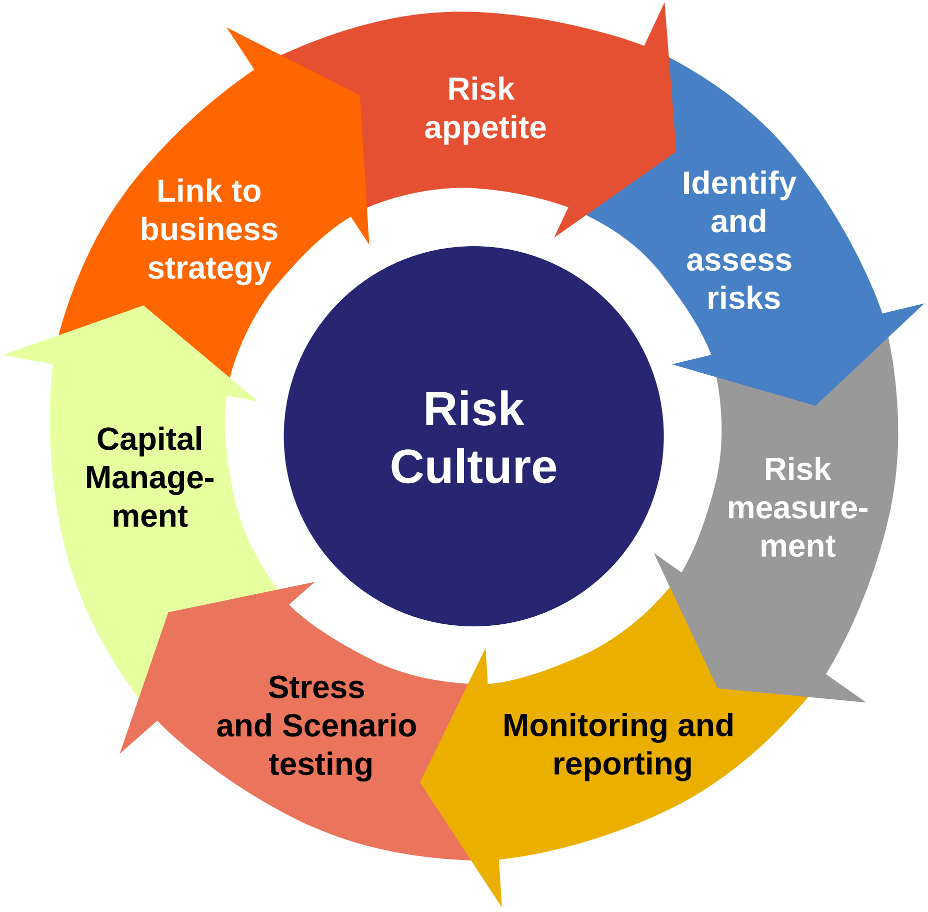
What has changed and why is it important?

- The NAIC has written a Guidance Manual that will require insurers to conduct an Own Risk and Solvency Assessment
- Insurers will submit a summary ORSA report to the state regulator for review on a regular basis
- Requires each insurer to prove that it has sufficient risk management practices in place and a framework to measure capital adequacy
- This will affect a broad cross-section of the insurance industry
  - Groups > $1B of direct written and assumed premium
  - Statutory entities > $500M in direct written and assumed premium
- The implementation of ORSA requirements could be in late 2012
  - The NAIC is feeling pressure to meet the 2012 FSAP requirements
  - Insurers are awakening to the inevitability of ORSA, but asking for more time

ORSA involves a self-assessment of the insurer's risk management framework

- ORSA examines the full scope of the insurer's risk management framework
- The prime purpose is to assess whether the components shown are currently adequate — and are likely to remain so — given current and future risks
- The "own" in ORSA places the onus on management — executives are responsible for conducting the ORSA and reporting the results to the board of directors
- The ORSA output is a set of documents that demonstrate the results of management's self-assessment

Enterprise Risk Management Framework

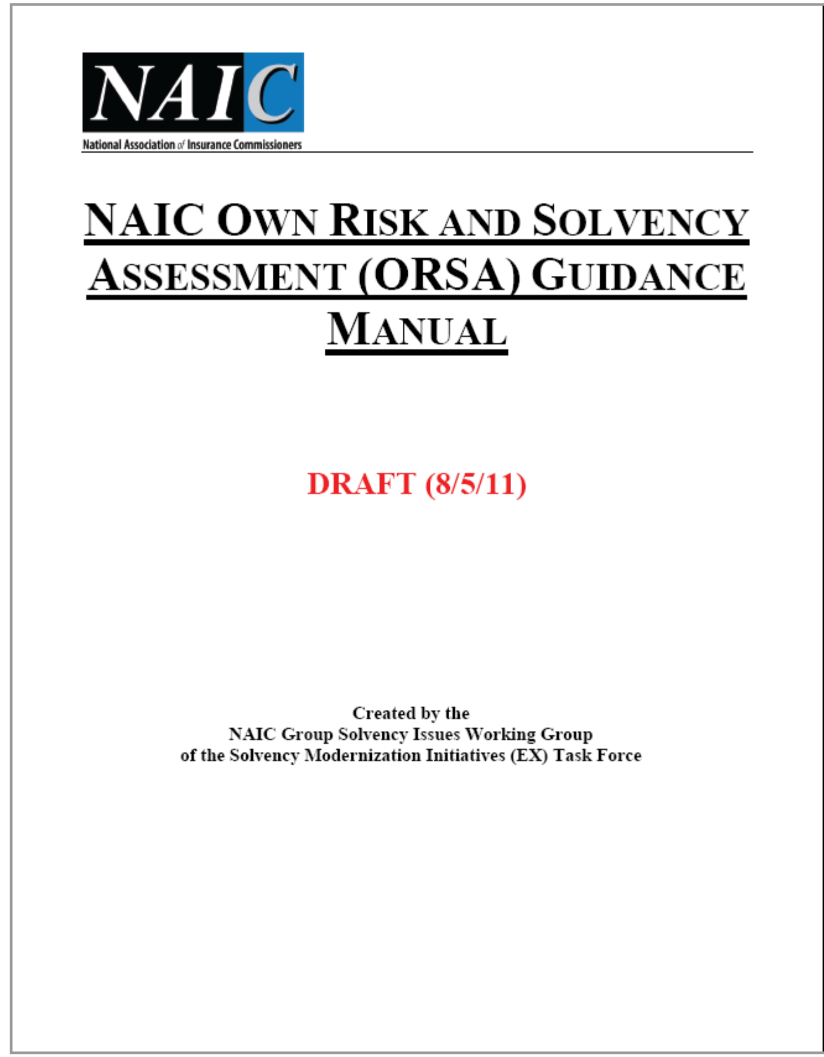


It should be conducted regularly to demonstrate that the risk framework remains relevant in the face of change

- Business strategy is reflected in the business plan, so ORSA should be consistent with the internal planning horizon
- The risk management system is *not* static — ORSA clearly states that it should be updated regularly and any time the insurer's risk profile changes e.g., acquisitions, new product offerings, etc.
- The risk management system should express how risk management and capital management relate to and interact with each other
  - "An insurer should determine the overall financial resources it needs, taking into account its risk tolerance, business plans, based on an assessment of its risks, the relationship between them and the risk mitigation in place" (IAIS, ICP 16.14.3)
- The regulatory review of ORSA is as much about the process as the numbers

Overview of current (8/5/11) ORSA guidance manual draft

- ORSA to be completed at least annually
  - Regulator may request a confidential filing
  - Industry push-back many limit the proposed scope of this filing
- Some insurers/groups may be exempt
  - Individual insurers with gross premium less than $500M
  - Groups with gross premium less than $1B
- Insurer's/Group's ORSA should contain three major sections:
  - Section 1 – Description of the Risk Management Policy
  - Section 2 – Quantitative Measurements of Risk Exposure in Normal and Stressed Environments
  - Section 3 – Group Economic Capital and Prospective Solvency Assessment


NAIC
National Association of Insurance Commissioners

NAIC OWN RISK AND SOLVENCY ASSESSMENT (ORSA) GUIDANCE MANUAL

DRAFT (8/5/11)

Created by the
NAIC Group Solvency Issues Working Group
of the Solvency Modernization Initiatives (EX) Task Force

Section 1 – Description of the Risk Management Policy

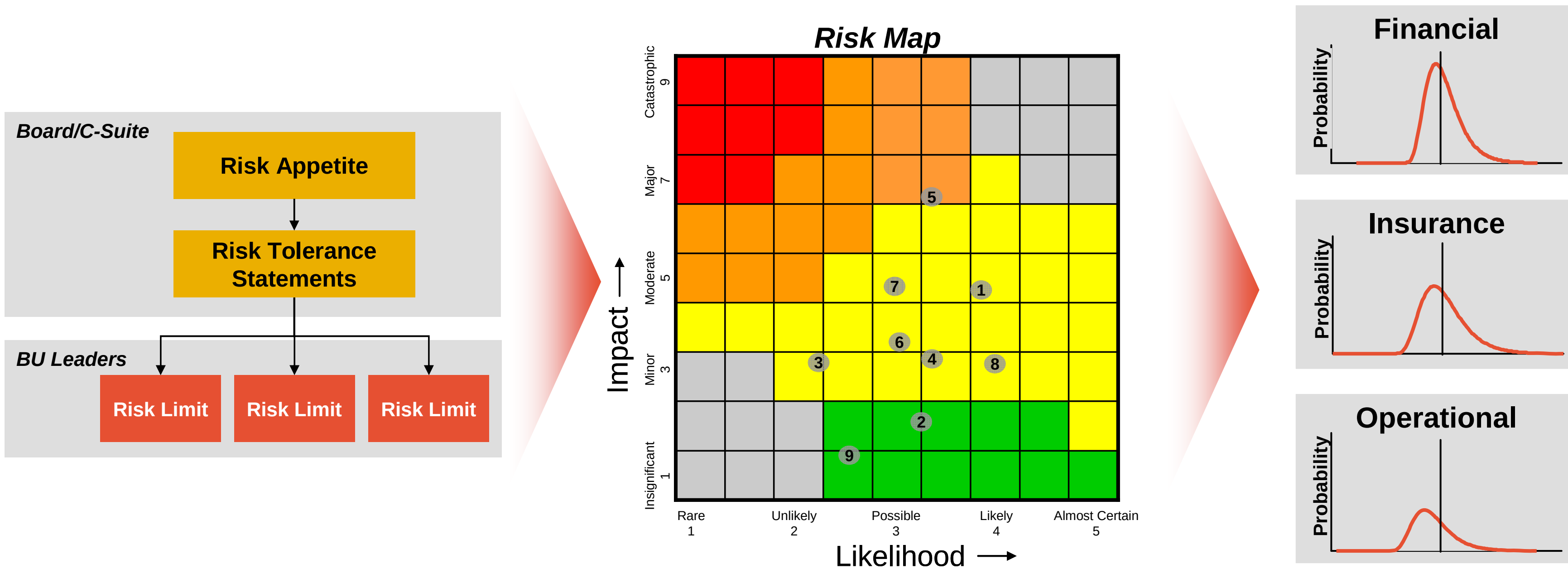
- Risk Culture and Governance
- Risk Identification and Prioritization
- Risk Appetite, Tolerances, and Limits
- Risk Management and Controls
- Risk Reporting and Communication

Risk Policy Documentation

- Investment
- Underwriting
- Claims underwriting/processing
- Anti-fraud
- Asset-liability management (ALM)
- Policy retention/discount/conservation
- Reinsurance counterparty
- Group membership
- Mergers and acquisitions
- Compensation and incentives
- All Other

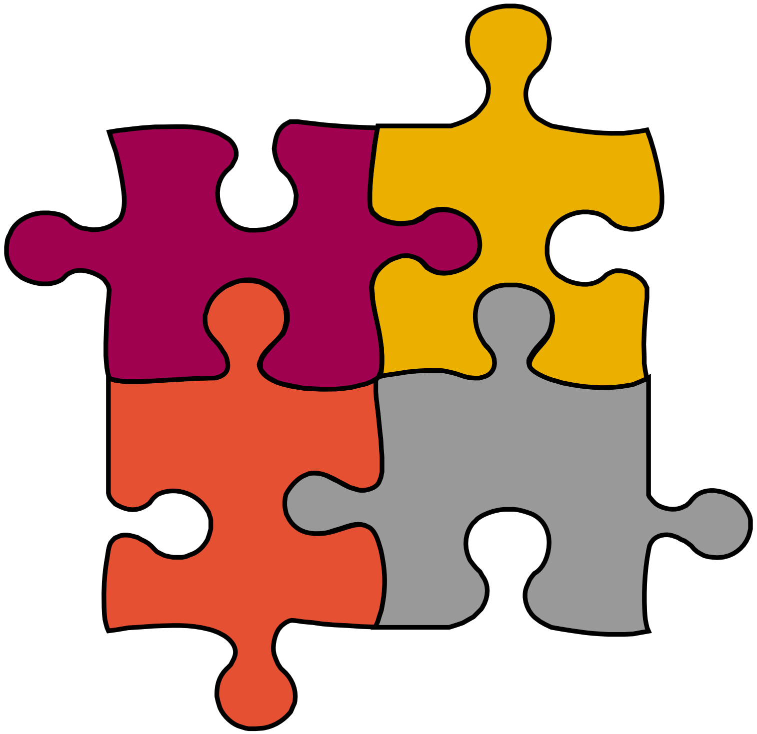
"The ORSA should disclose how the insurer's management uses the risk management policy including any tolerance statements and limits in its day-to-day operations"

Section 2 – Quantitative Measurements of Risk Exposure in Normal and Stressed Environments



- Companies may be required to provide the following by risk category (e.g., Mortality Risk or Reserving Risk):
  - Notional Amount
  - Expected Value (Normal conditions)
  - Expected Value (stressed conditions)
  - Reverse Stress Test Factor
  - Measurement Type

Section 3 – Group Economic Capital and Prospective Solvency Assessment



- Group EC
  - Definition of solvency
  - Time horizon of risk exposure
  - Risks to model
  - How risks are quantified
  - Measurement metric
  - Target level of capital
  - Reflecting diversification
- Prospective Solvency Assessment
  - 2 – 5 year look forward
  - Demonstrate and document that there is a link between the 2 – 5 year business strategy and the amount and quality of capital, and if necessary, the source(s) of capital needed to support the business strategy

The NAIC has been developing a Guidance Manual for regulators to use in the implementation of ORSA

February

11
- NAIC issues **"U.S. Own Risk and Solvency Assessment (ORSA) Proposal"**

2/11 – 3/18
- Comment period

March

18
- Comment period ends

June

20
- Towers Watson releases Insights article, "Insights: NAIC's ORSA: A Broader Approach to Regulation"

July

7
- NAIC issues initial guidance draft, **"NAIC Own Risk and Solvency Assessment (ORSA) Guidance Manual"**

21
- NAIC hosts "2011 ERM Symposium": CRO Council members present on ERM

25
- NAIC releases revised guidance manual draft

The Manual will be refined over the next couple of months and will be ready for use at the end of the year

August		October	November

August

2
- Towers Watson releases update to Insights ORSA article

5
- NAIC target date to finalize guidance manual draft to send to industry for comments

28 – 31
- GSIWG National Meeting (to review newly revised draft of ORSA proposal)

October
- GSIWG Public Hearing on ORSA (final edits before adoption)

November
- SMI Task Force
  - Receive and discuss proposal

The NAIC has not announced an exact date for ORSA implementation — the NAIC feels pressure to meet 2012 FSAP requirements but companies are pushing for a longer timeline

Key questions that US insurers should consider in assessing their ORSA readiness…

- Are you aware of the ORSA and what it will require?
- How will ORSA affect your organization over the next 12 – 24 months?
- Have you formally identified and prioritized key risks to the business strategy?
- Has your executive team worked with the board to articulate a risk appetite?
- Do current risk policy documents reflect the firm’s appetite for risk?
- Are policy documents in place for all key risk areas e.g., underwriting, investment, claims, mergers and acquisitions, etc.?
- Do you have measurement tools in place to analyze the firm’s key risk exposures?
- Have you linked the output of your risk modeling to strategy and risk policies?
- Is there an active feedback loop between the risk analysis and strategic planning functions?

Things to consider when preparing for the ORSA

Establish Risk Management Vision	• Establish a clear set of objectives for the ORSA • Understand and measure current risk culture of the organization • Start embedding process
Establish Governance	• Define and educate key stakeholders • Establish sign-off process
Documentation	• Develop first draft of ORSA report • Develop first draft of ORSA policy • Identify links to existing or planned documents
ORSA Activities	• Review regulatory programs to ensure all activities are covered
Perform Gap Analysis	• Identify activities and models where further improvement is required • Monitor worldwide developments

ORSA is not just a regulatory requirement — it is an opportunity to enhance core business processes

- Improving risk awareness and foresight
  - More insightful decision making
  - Forward looking and proactive risk management
- Focusing management attention on risks that matter
  - Focus on regular, current and relevant information
- Increasing alignment of risk appetite and business strategy
  - ORSA pulls together existing ERM components
- Improving capital efficiency
  - Reduce cost of capital through better management of volatility
  - Uncover natural hedges
- An internal model, without the formal approval process!

A.M. Best's Approach to ERM & Observations from the New ERM SRQ Questions

Las Vegas, NV
September 15, 2011

Thomas M. Mount, ACAS, MAAA

What is Risk Management?

- Let’s keep it simple…*every company does some form of risk management*
- AMB defines risk management as the risk and capital management process(es) and practice(s) employed by a company

Risk Management = (Identify + Understand + Measure + Manage) Risk

- No two companies are exactly alike
- AMB’s assessment of risk management respects the unique nature of every company we rate

Executive Summary

Our goal is to get the **conversation** back on the core analytical process and create a **common platform** that applies to all insurers…large and small

- **Conversation**…the credit rating process, including the assessment of risk management, is interactive
  - Two-way dialogue on the key rating factors
  - Recognizes there are many different paths to success
  - NOT prescriptive…NOT driven by buzz words
- **Common platform**…the underlying fundamentals of the credit rating process, including the assessment of risk management, should apply to all entities we rate

AMB is Looking for a Practical Approach to Risk Management

- Tailored to your business and risk profile
  - Process must fit your company, not the other way around
  - Pick the right tool for the job, not just the most expensive one
  - Risk management will be defined differently by each company
- Function over form
  - CRO's and sophisticated models are not absolute pre-requisites for strong risk management
  - For some insurers, strong risk management may be a more traditional approach supplemented by an understanding of how risks correlate
- Flexible and adaptive to the changing business environment
  - Strong risk management is not a finitely defined set of tasks
  - Ongoing process…emerging risks…risk learning

Risk Management and the Rating Process…

- Top 5 Exposures and Critical Success Factors to Mitigating/Managing these Risks
- Lessons Learned through your Risk Management Development Process
- "Risk Management Questions You Should Address at Every Rating Meeting"
- Next Steps in Risk Management Development

AMB recognizes risk management is an ongoing process.
Demonstrating commitment and progress toward a goal is the key.

Questions You Should Address at Every Rating Meeting

- What is the Board's and Senior Management's role in your risk management framework?
- Has your organization established and communicated any risk management objectives to your employees, and other stakeholders?
- What is your risk appetite? How is it measured?
- How does your organization encourage good risk-based decision making?
- What is your organization's process for identifying and cataloging key risks across your organization?

Questions You Should Address at Every Rating Meeting

- What tools does your organization use to determine required capital? Is it a static, dynamic, or hybrid approach?
- How do you factor in correlation/dependency of individual risks?
- How are liquidity, cash flows, and financial flexibility incorporated into your risk management framework?
- How do you incorporate operational risk and strategic risk in your evaluation of required capital?
- How are emerging risks identified and evaluated?

What Should You Share with AMB?

- Provide AMB whatever materials you feel will help us understand how your organization defines and strives for strong ERM
  - Demonstrate how you identify, understand, measure and manage risk
  - Sample reports used by Board, senior management, etc.
  - De-briefing on how risk tools were used to make a strategic or tactical decision…**the USE TEST!**
  - Internal or external assessments of your overall process, or components of your process

BCAR Models vs. Internal Capital Models

Determining Required Capital (Let's Talk)

- Determination of required capital is be based on an interactive dialogue comparing
  - Company's view of capital (e.g. ICM)
  - BCAR score and historical trends
  - Holding company issues
  - Other models or metrics

ICM Approach – Integrated within ERM Discussions

- AMB dialogue on capital management includes a review of key underlying elements of ICM process and results, or whatever tools or metrics the company uses to determine required capital
- Incorporated within the credit rating evaluation process, either at annual rating meeting or as a supplement to annual meeting
- AMB discussion/review is not an "audit"
- Objective is to better understand the underlying drivers of the differences between view of risk-adjusted capital per your ICM or other metrics used vs. BCAR

ERM – P/C SRQ Questions

Enterprise Risk Management SRQ Questions

Serve as a consistent starting point for analyst's discussion about the rating unit's risk management

- Cover main areas
  - Risk Culture
  - Risk Identification/Measurement/Monitoring
  - EC Models/Use Test
  - What If Scenarios

Enterprise Risk Management
SRQ Questions

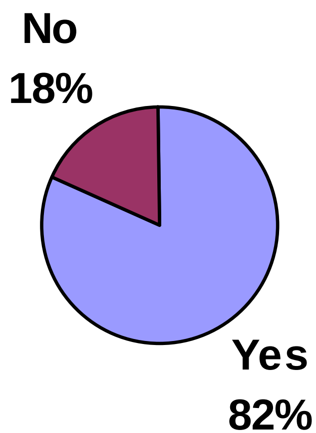
Do you have a CRO or Senior Level Officer responsible for ERM?

Risk Culture - All Respondents

Commercial	Yes	81%
56%	No	19%
Personal	Yes	82%
44%	No	18%

Large	Yes	91%
31%	No	9%
Medium	Yes	83%
33%	No	17%
Small	Yes	72%
36%	No	28%

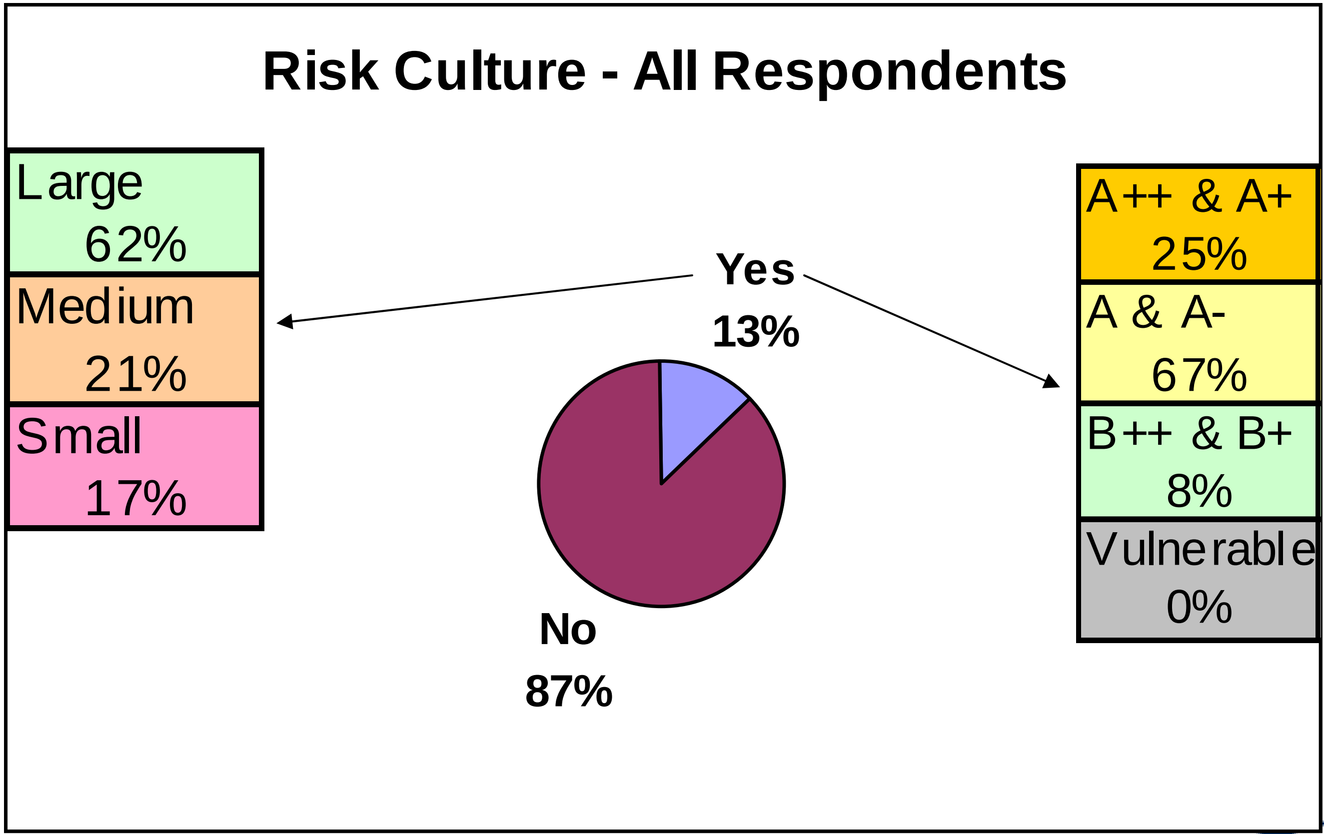
(PHS: 0-50m,50-250m,>250m)



A++ & A+	Yes	92%
12%	No	8%
A & A-	Yes	84%
68%	No	16%
B++ & B+	Yes	67%
17%	No	33%
Vulnerable	Yes	76%
3%	No	24%

Enterprise Risk Management SRQ Questions

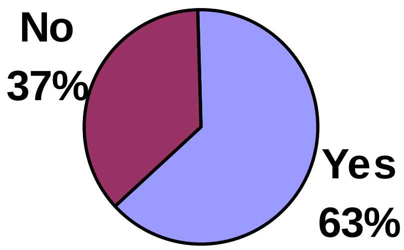
Is the CRO an autonomous position responsible only for ERM?



Enterprise Risk Management SRQ Questions

Do you have an ERM committee?

Risk Culture - All Respondents



For those that did not have a CRO, did they have an ERM committee?

Yes	34%
No	66%

For the 12% overall that had neither:

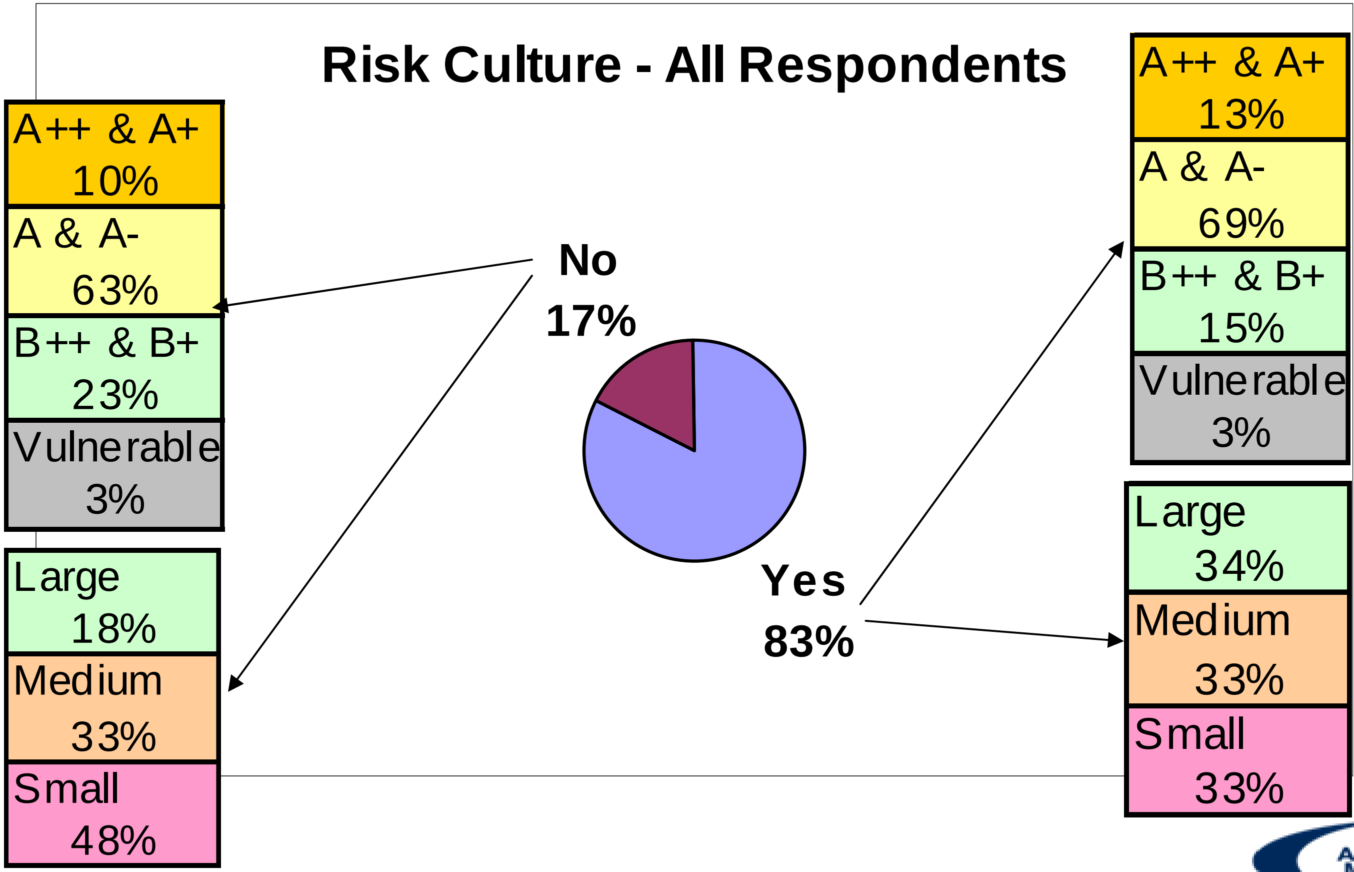
Large	3%
Medium	34%
Small	62%

Lift from parent

A++ & A+	2%
A & A-	60%
B++ & B+	33%
Vulnerable	5%

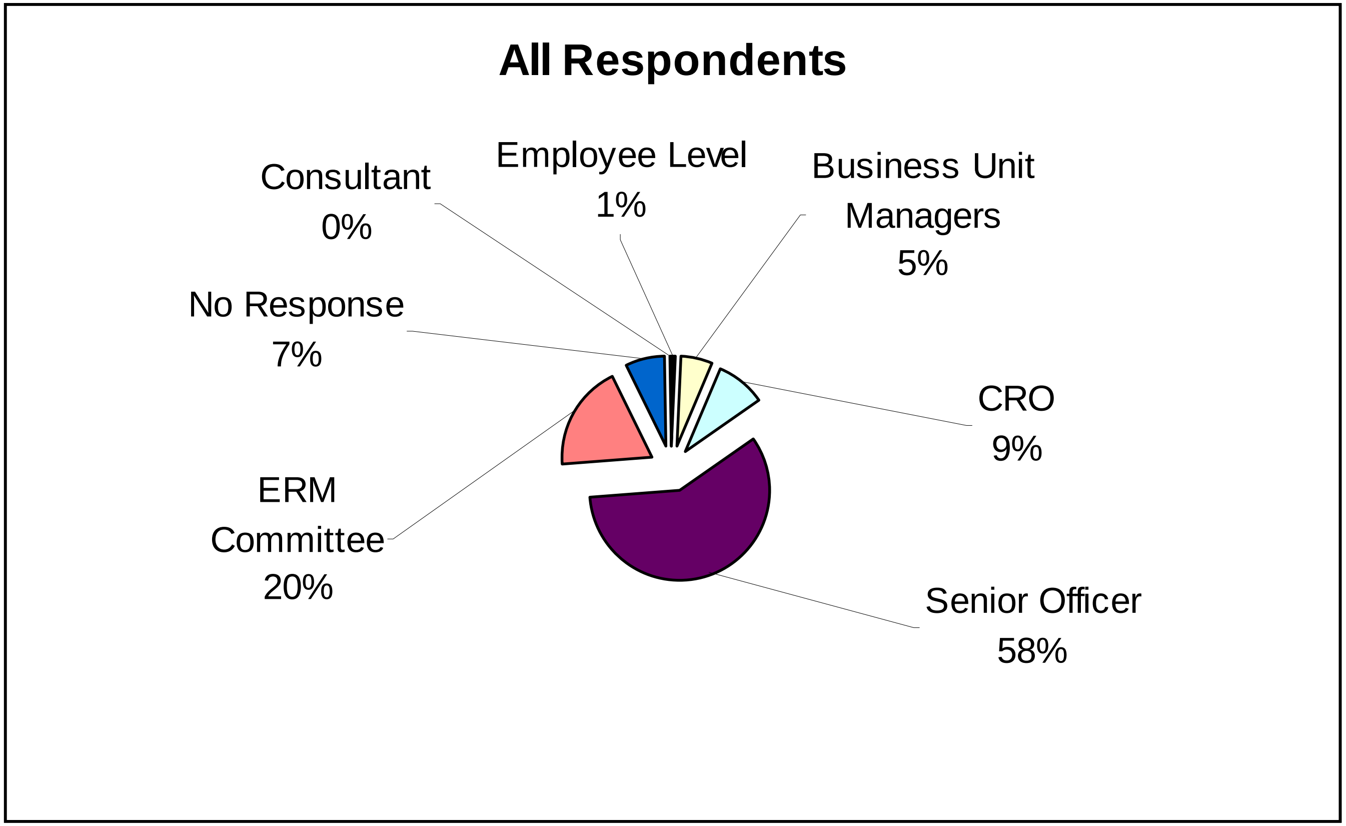
Enterprise Risk Management SRQ Questions

Are the rating unit's strategies driven by Risk/Return measures?



Enterprise Risk Management SRQ Questions

Who is most responsible for identifying material risks to the rating unit's financial position?



Enterprise Risk Management
SRQ Questions

Within each risk type, what has management identified to be its largest potential threat to the overall financial strength of the rating unit?

Market Risk	
17%	Interest rate increase (of 100-300 bps)=1%-28% of PHS
14%	Stock market decline (of 10% to 60%) =1%-24% of PHS
12%	Combination of Equity decline and Increase in Interest rates=2%-52% of PHS

Credit Risk	
32%	Reinsurer Default (All, Some, Partial) = 0.6%-120% of PHS
11%	Bond Default (Muni, Single Issue, State, etc)=0.1%-11% of PHS
2%	Agency default, Policyholder default=0.5%-9% of PHS

A.M. BEST

Enterprise Risk Management SRQ Questions

Within each risk type, what has management identified to be its largest potential threat to the overall financial strength of the rating unit?

Underwriting Risk	
24%	Natural Catastrophe (One or more) = 1%-57% of PHS
14%	Inadequate/Soft Pricing = 1%-38% of PHS
5%	Adverse Reserve Devlopment = 1%-30% of PHS
4%	Regulatory/Legislative/Judicial = 1%-13% of PHS

Operational Risk	
14%	Business Int. due to IT Failure/Breach = 1%-21% of PHS
7%	Business Int. due to Home Office Catastrophe = 1%-11% of PHS
4%	Employees Training/Succession/Turnover = 1%-4% of PHS

Enterprise Risk Management SRQ Questions

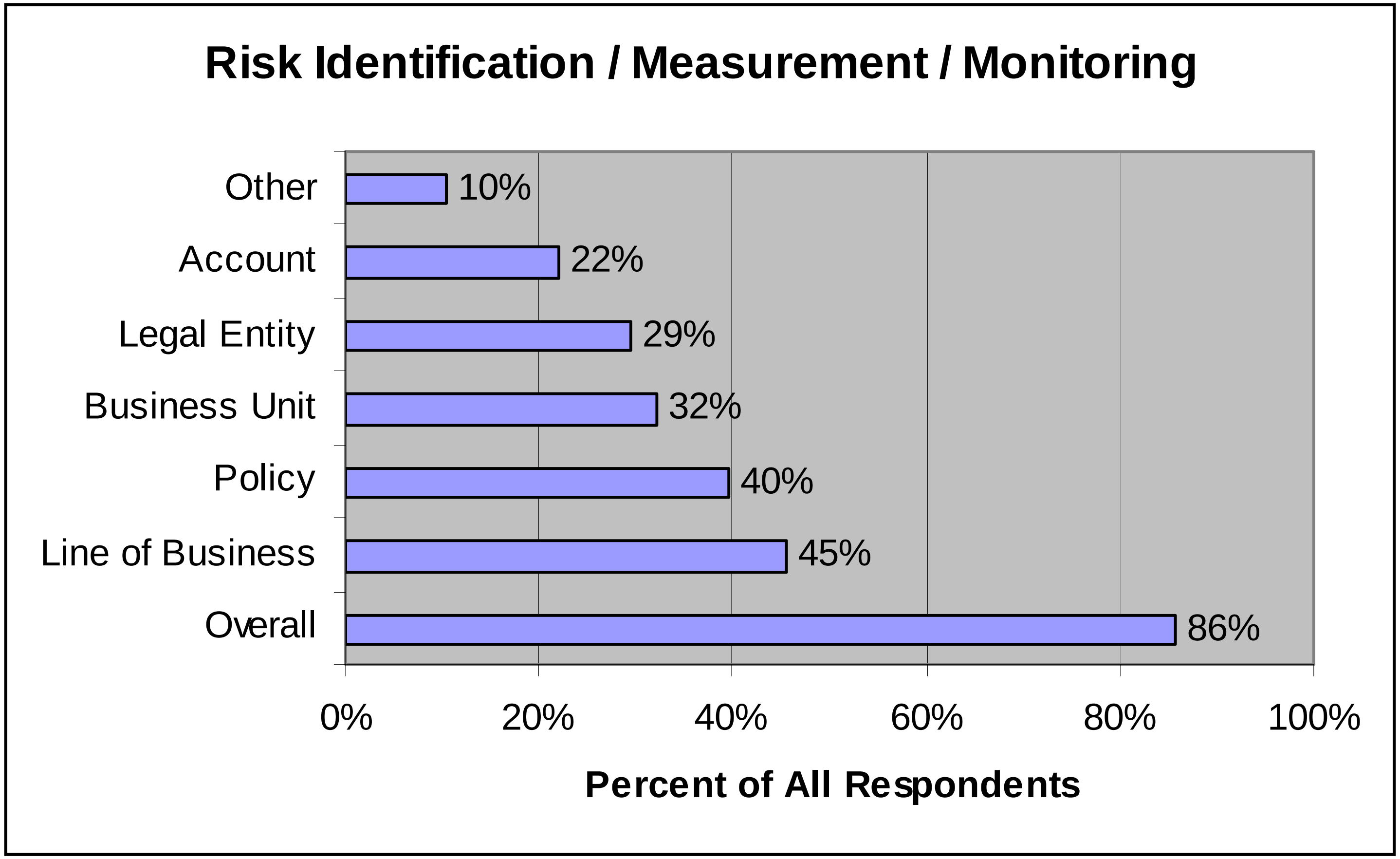
Within each risk type, what has management identified to be its largest potential threat to the overall financial strength of the rating unit?

Strategic Risk	
12%	Increased Competition = 1% - 28% of PHS
6%	Growth = 1%-38% of PHS
4%	Loss of Agent/Distribn. Channel=1%-13% of PHS
2%	Loss of AMBest Rating = 2%-10% of PHS

Liquidity Risk	
15%	"Don't Worry"/No Liquidity Risk = 0%-1.4% of PHS
11%	Catastrophe Related = 0.3% - 33% of PHS
6%	Muni or Other Bond mkt Collapse=2.6%-22% of PHS
2%	Bank default/Sources of Credit Disappear = 2%-2.7% of PHS

Enterprise Risk Management SRQ Questions

At what level do you define risk tolerance?



Enterprise Risk Management SRQ Questions

What is management's overall appetite/tolerance for risk?

Inadequate Responses:
Highly conservative, Moderately conservative
Generally conservative at most moderately conservative
Low, Very Low, Low to moderate
Primarily low, with some tolerance for medium
Risk averse, Very limited
Maintain 250 BCAR

At least 90% of the responses fell into the category of Inadequate Responses!

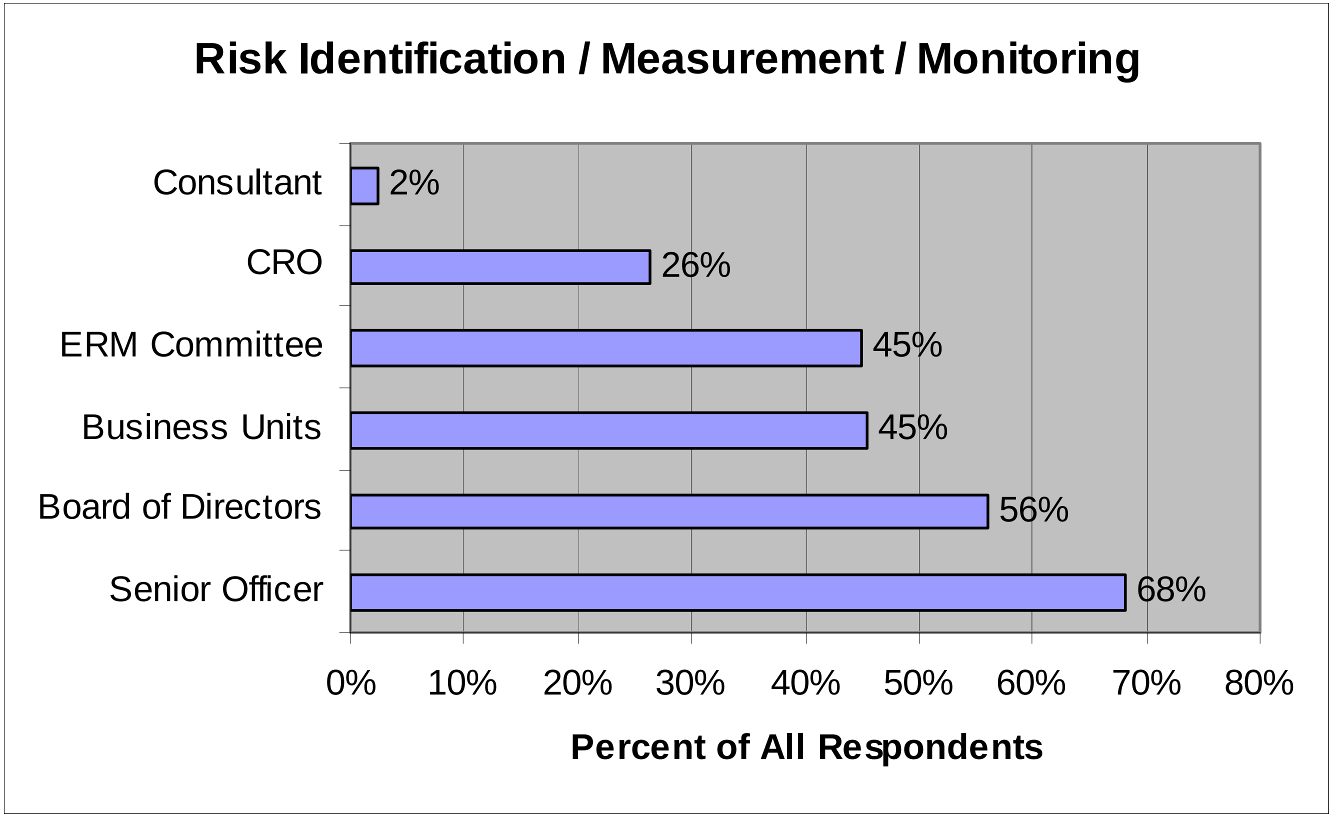
Adequate Responses:

Appetite-Minimum limits NSA writer in state x w/low volatility in avg return of y%; Medium size WC account manufacturing risks in all states w/retained limits of $x w/high volatility in avg return of y%; $1m+ Homes in hurricane exposed states but purchase reins so that…

Tolerance-No more than a 2% chance of losing 10% of PHS Annually; 0.5% risk of insolvency over x year period; UW loss no more than once every 15 years and not to exceed more than 10% of PHS

Enterprise Risk Management SRQ Questions

Who receives exception reports when risk tolerances are exceeded?



Enterprise Risk Management SRQ Questions

- What lines of business or types of risk does management believe to be most correlated that could threaten its financial strength?
  - Sample responses that would be acceptable to analyst:
    - WC & GL
    - Large Cat & Reinsurer default
    - Inflation, Pricing, and Reserves
    - Cat loss & investment in a company located in that area
    - Cat loss & home office damaged (operational risk)
  - Sample responses that should be questioned by analyst:
    - “None” (ie no risks) or N/A
    - Monoline insurer
    - EQ & Hurricane

Enterprise Risk Management
SRQ Questions

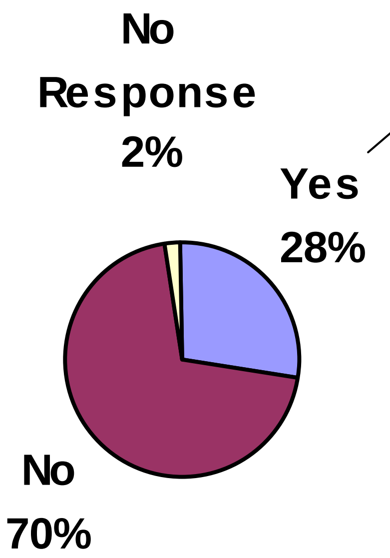
Do you use an EC model to quantify your aggregate risk?

EC Models - All Respondents

Commercial	54%
Personal	46%

Large	23%
Medium	35%
Small	42%

A++ & A+	9%
A & A-	68%
B++ & B+	18%
Vulnerable	4%



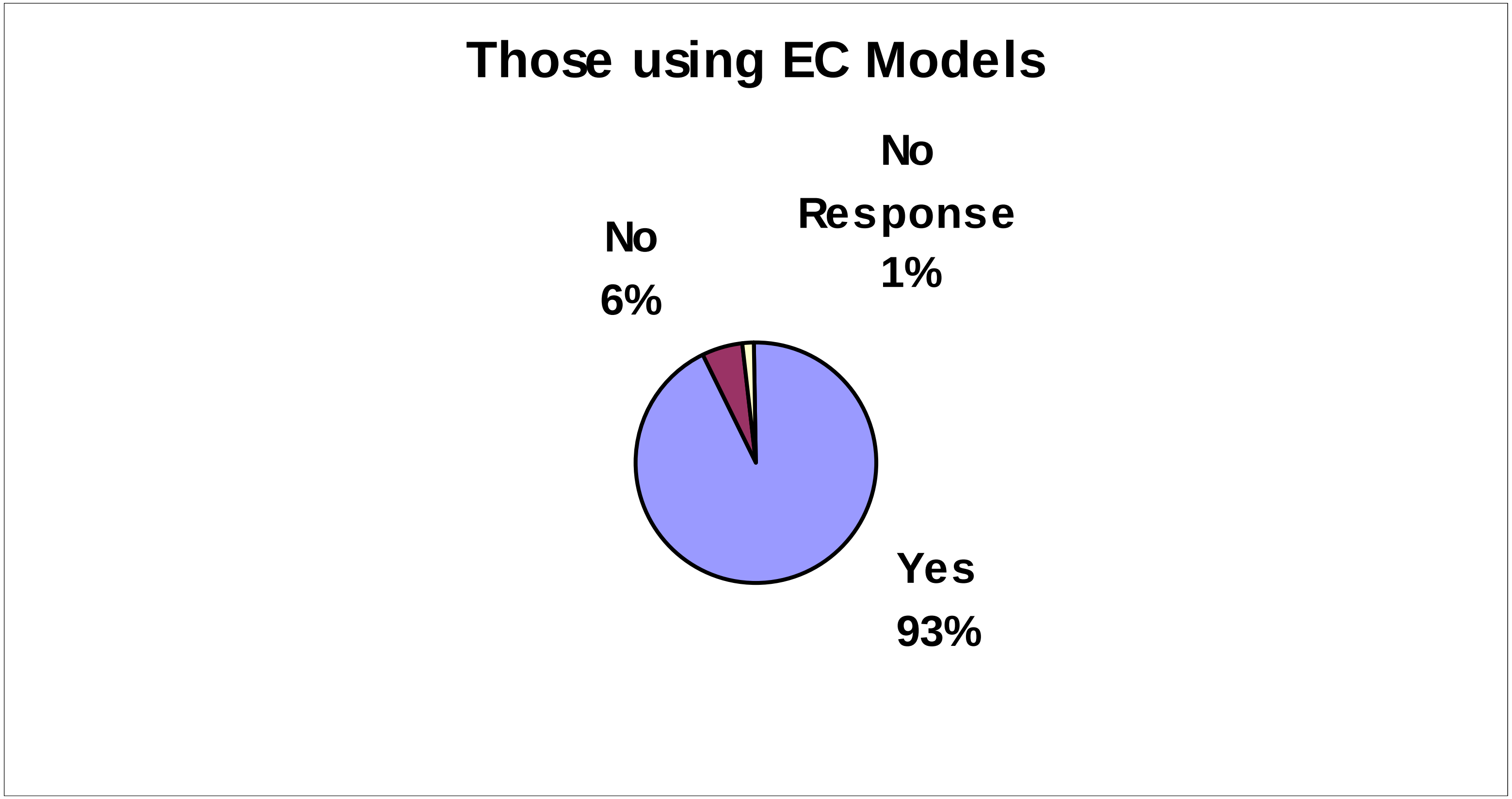
Commercial	60%
Personal	40%

Large	52%
Medium	32%
Small	16%

A++ & A+	21%
A & A-	70%
B++ & B+	9%
Vulnerable	1%

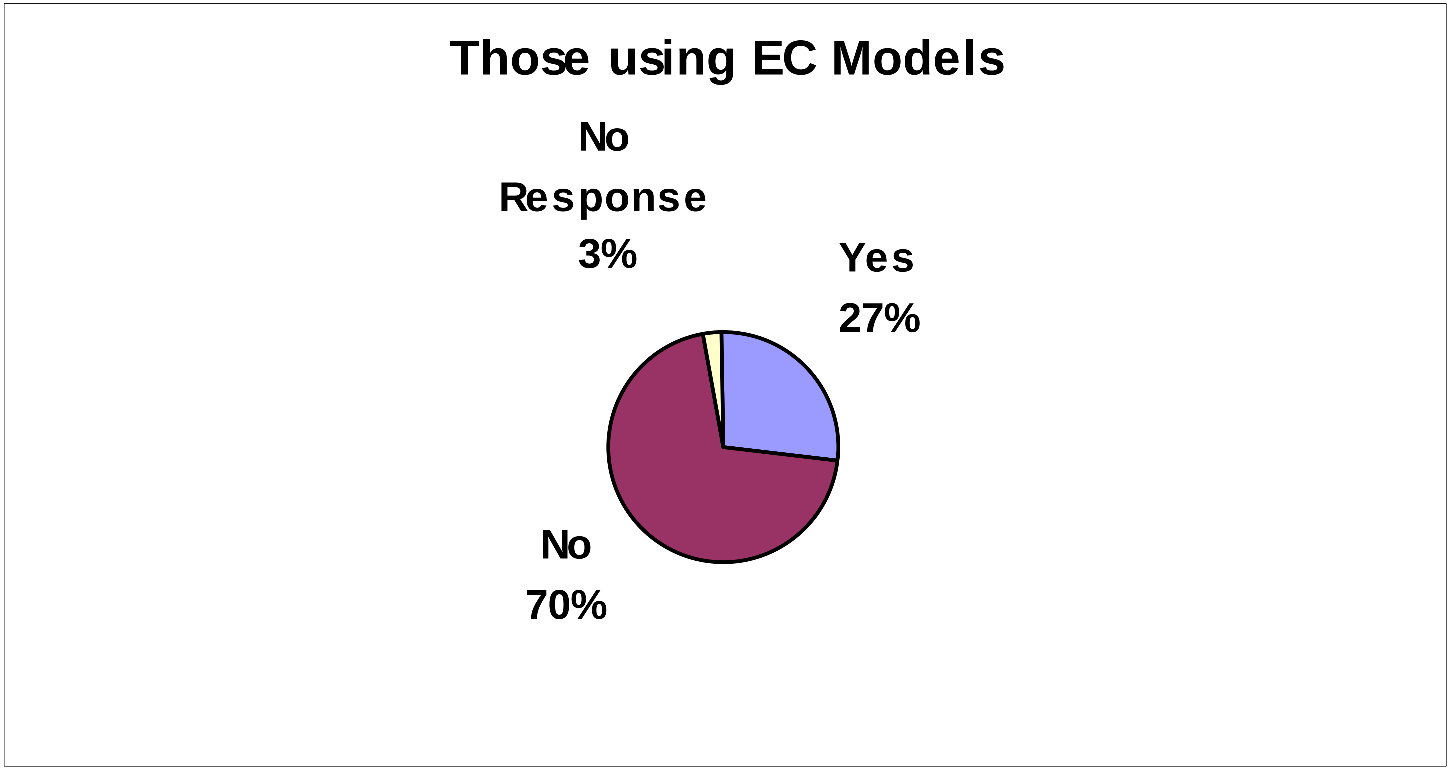
Enterprise Risk Management
SRQ Questions

Do you **<u>use</u>** the EC model to make <u>key</u> business decisions?



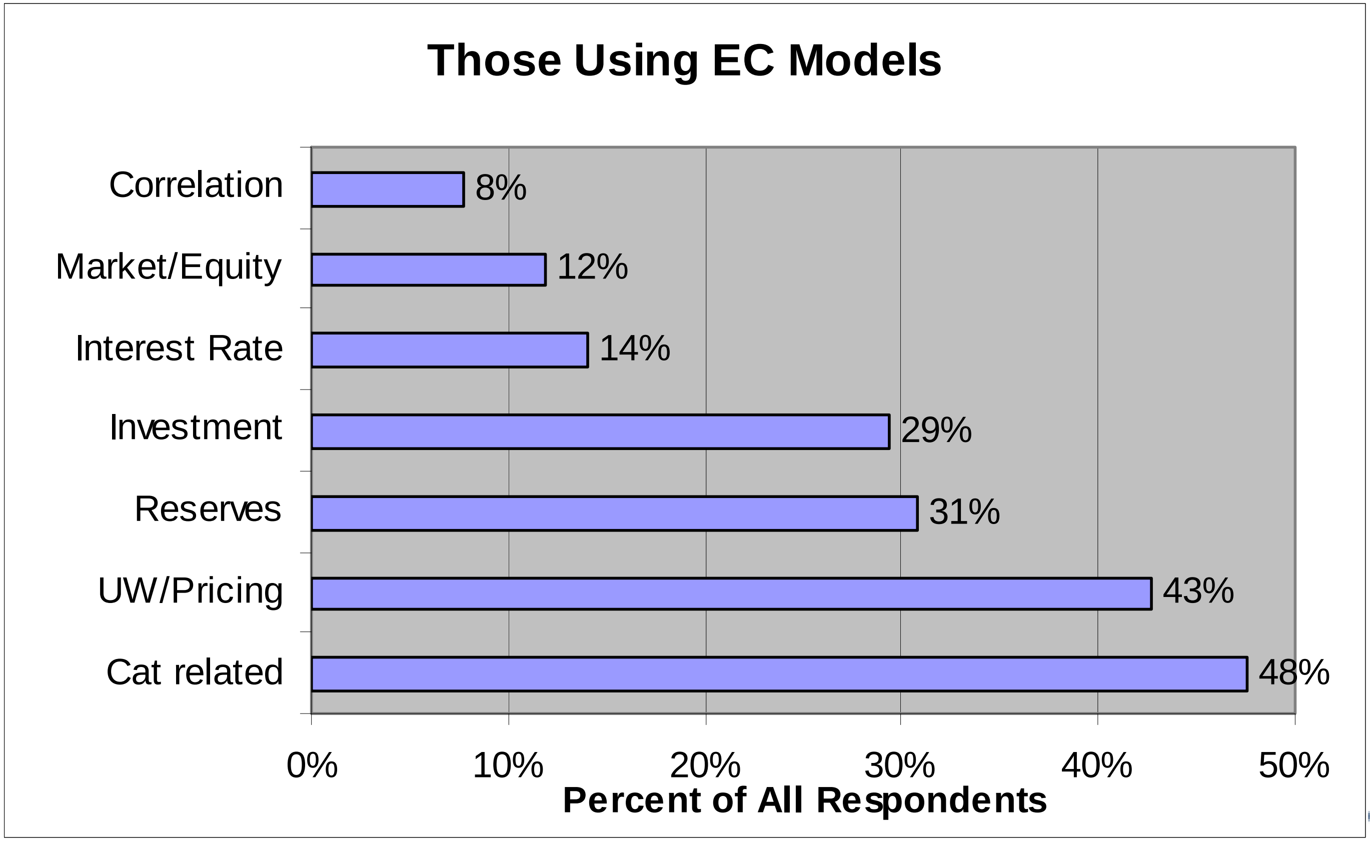
Enterprise Risk Management SRQ Questions

Do you **<u>use</u>** the EC model to determine any portion of management compensation?



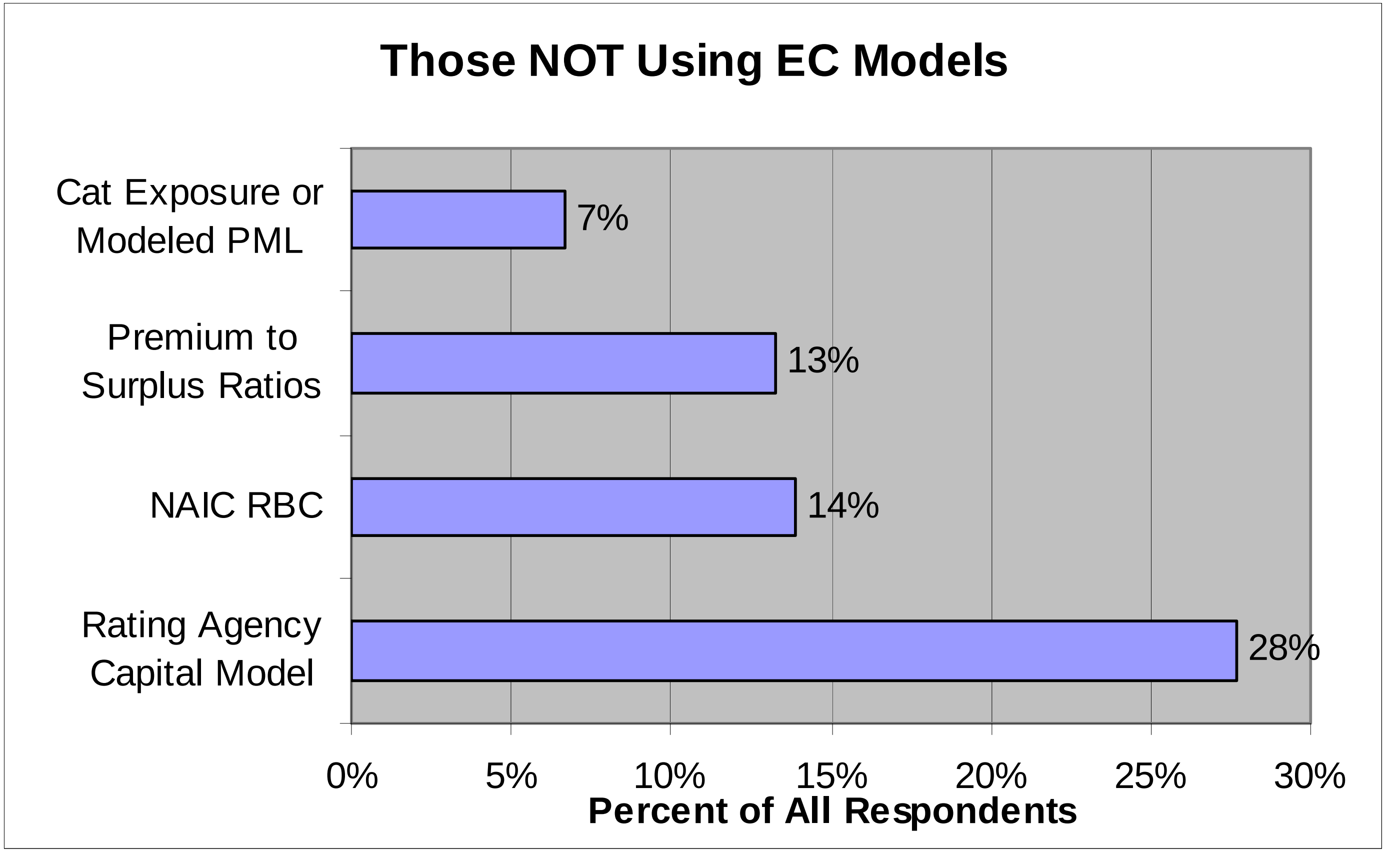
Enterprise Risk Management SRQ Questions

What are the 3 key drivers (or parameters) of the EC model that have the greatest impact on financial strength or earnings volatility?



Enterprise Risk Management SRQ Questions

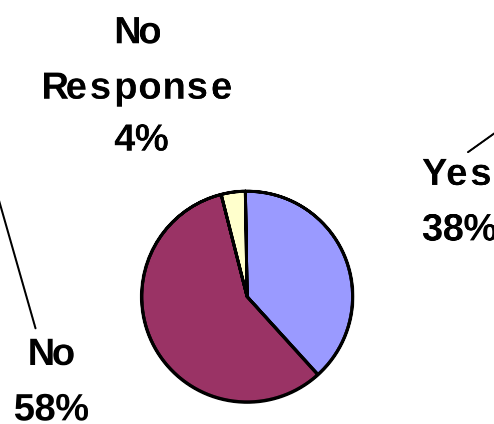
If an EC model is not used, how does management determine its overall capital adequacy and allocation of capital to business units, lines or risk categories?



Enterprise Risk Management
SRQ Questions

Does your rating unit estimate the potential impact of future changes in general inflation on its current net loss reserve position?

Inflation - All Respondents



Do not estimate impact:

Commercial	51%
Personal	49%

Large	21%
Medium	36%
Small	43%

A++ & A+	13%
A & A-	65%
B++ & B+	17%
Vulnerable	5%

Do estimate impact:

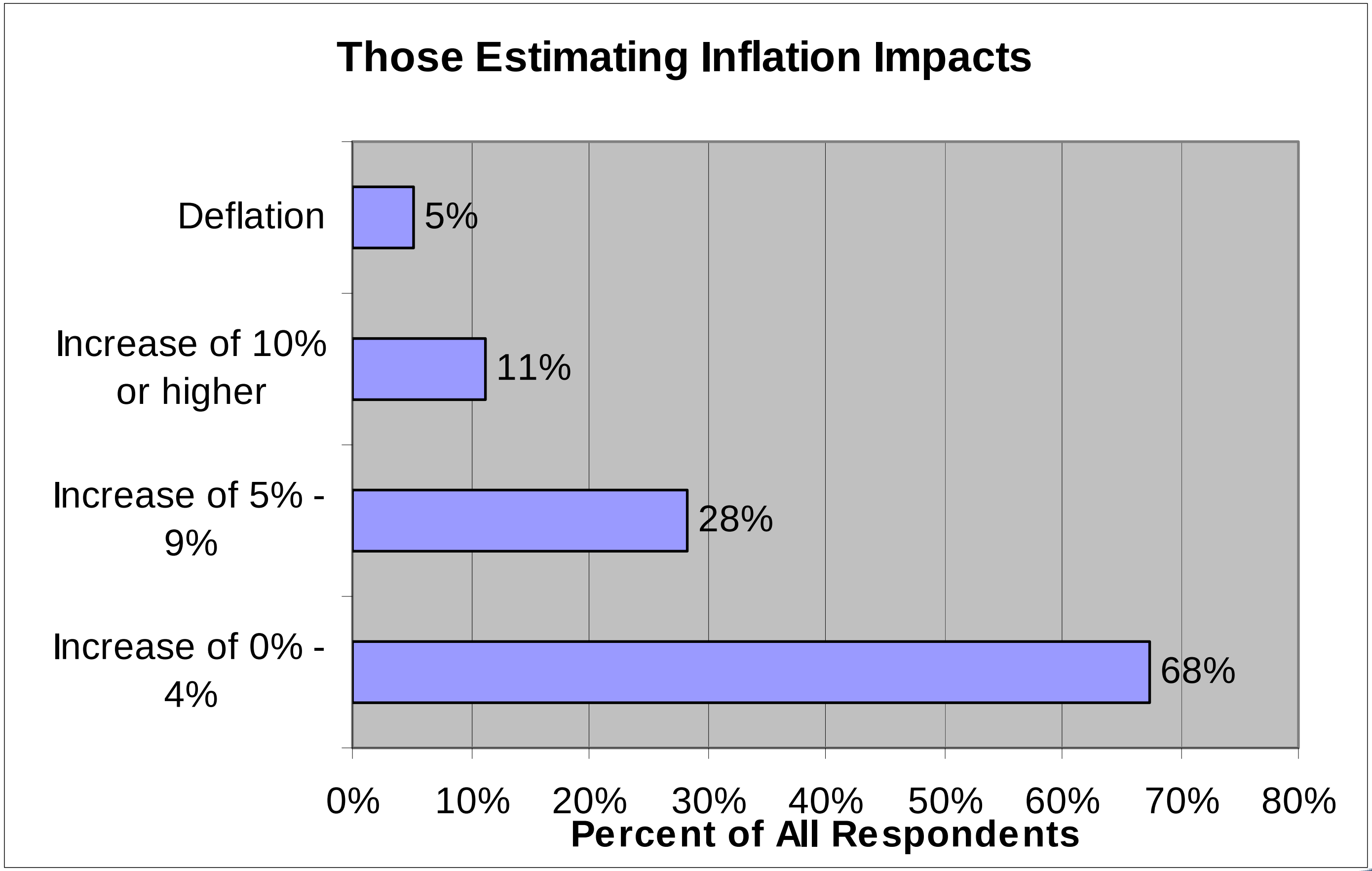
Commercial	65%
Personal	35%

Large	49%
Medium	29%
Small	22%

A++ & A+	13%
A & A-	75%
B++ & B+	12%
Vulnerable	1%

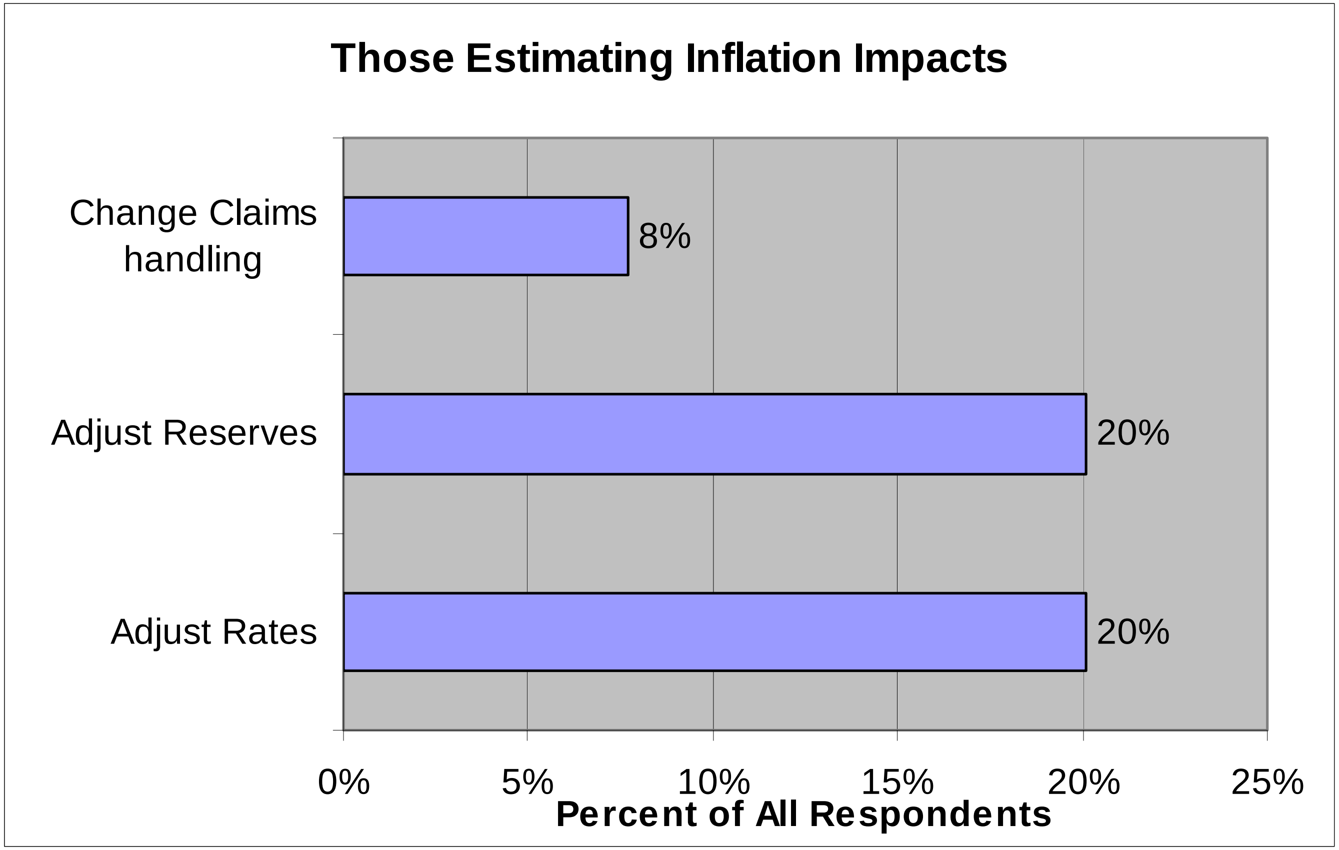
Enterprise Risk Management SRQ Questions

Description of General Inflation Stress Scenarios:



Enterprise Risk Management SRQ Questions

Planned Mitigation Strategy for Inflation Stress Scenarios:



Wrap-Up and Q&A

ERM concluding remarks

- ERM should be thought of as continuous “enhancements” to your risk management program that will ensure your company success
- ERM is not a fad — more and more of your peers are embracing it as good business practice and extracting practical benefits
- Both the NAIC and A.M. Best are increasing their ERM requirements which will accelerate companies’ ERM development in the next couple of years
- All insurers should be prepared in their A.M. Best meetings to articulate their risk management approaches in the context of Best’s hot buttons and new SRQ questions
- Insurers are leveraging many practical tools to advance their ERM program
- ERM is a multi-year journey that requires ongoing assessments of:
  - Where are we now and where are we going in the future?
  - Are we staying ahead of evolving regulatory and rating agency changes?
  - What approach is most appropriate for my company’s risk profile and culture?
  - What practical tools and methods can we use to extract tangible value?


Thank you!