

# The Economic Capital Conversation with Company Leadership

Casualty Loss Reserve Seminar, September 2016

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# Erie Insurance Group



- ▶ Founded in 1925
- ▶ Home office in Erie, Pennsylvania
- ▶ Property & Casualty insurer w/ Life affiliate
- ▶ Reciprocal, managed by Erie Indemnity Company
- ▶ Regional carrier (12 states and DC)
- ▶ \$5.9 billion written premium
- ▶ 15<sup>th</sup> largest P&C insurer in U.S.
- ▶ A+ AM Best rating
- ▶ Above all in SERVICE<sup>SM</sup>



Erie Insurance  
Exchange

Erie Family  
Life

Erie Indemnity  
Company

The comments, views and opinions expressed in this presentation and on the following slides are solely those of the presenter and not necessarily those of ERIE Insurance Group.

Values listed in the following slides are fictitious and for demonstration purposes only.

## What we say to dogs

Okay, Ginger! I've had it!  
You stay out of the garbage!  
Understand, Ginger? Stay out  
of the garbage, or else!



## What they hear

blah blah GINGER blah  
blah blah blah blah blah  
blah blah GINGER blah  
blah blah blah blah...



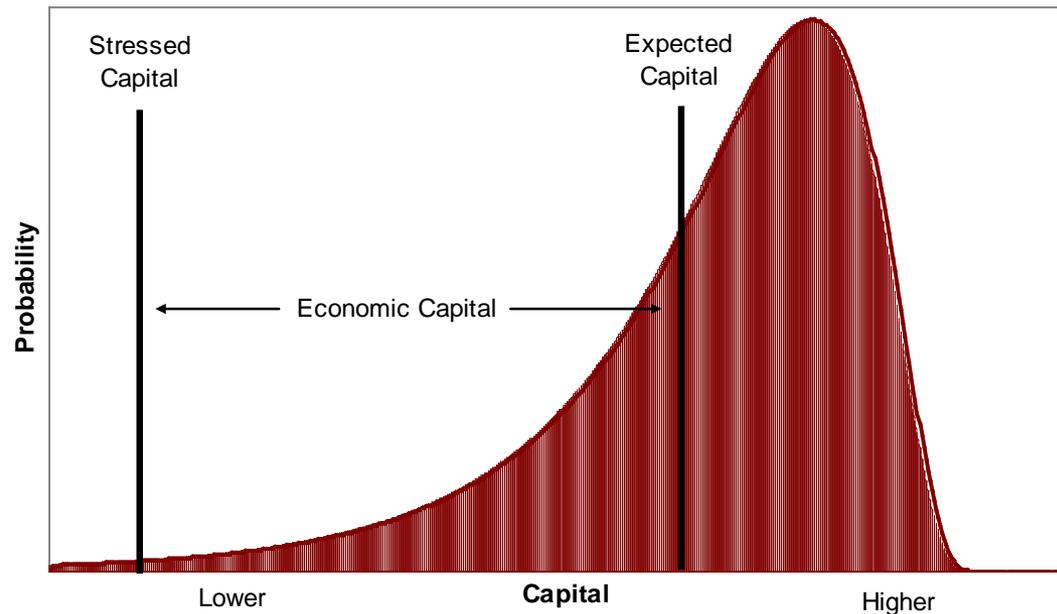
# Economic Capital 101

- ▶ “Methods or practices to attribute capital to cover the economic effects of risk-taking activities.” Basel III (2011)
- ▶ “Amount of capital an organization requires to survive or to meet a business objective for a specified period of time and risk metric, given its risk profile.” ASOP 46 (2012)
- ▶ “Sufficient surplus to cover potential losses at a given risk tolerance level over a specified time horizon.” Institute of Actuaries of India (2009)

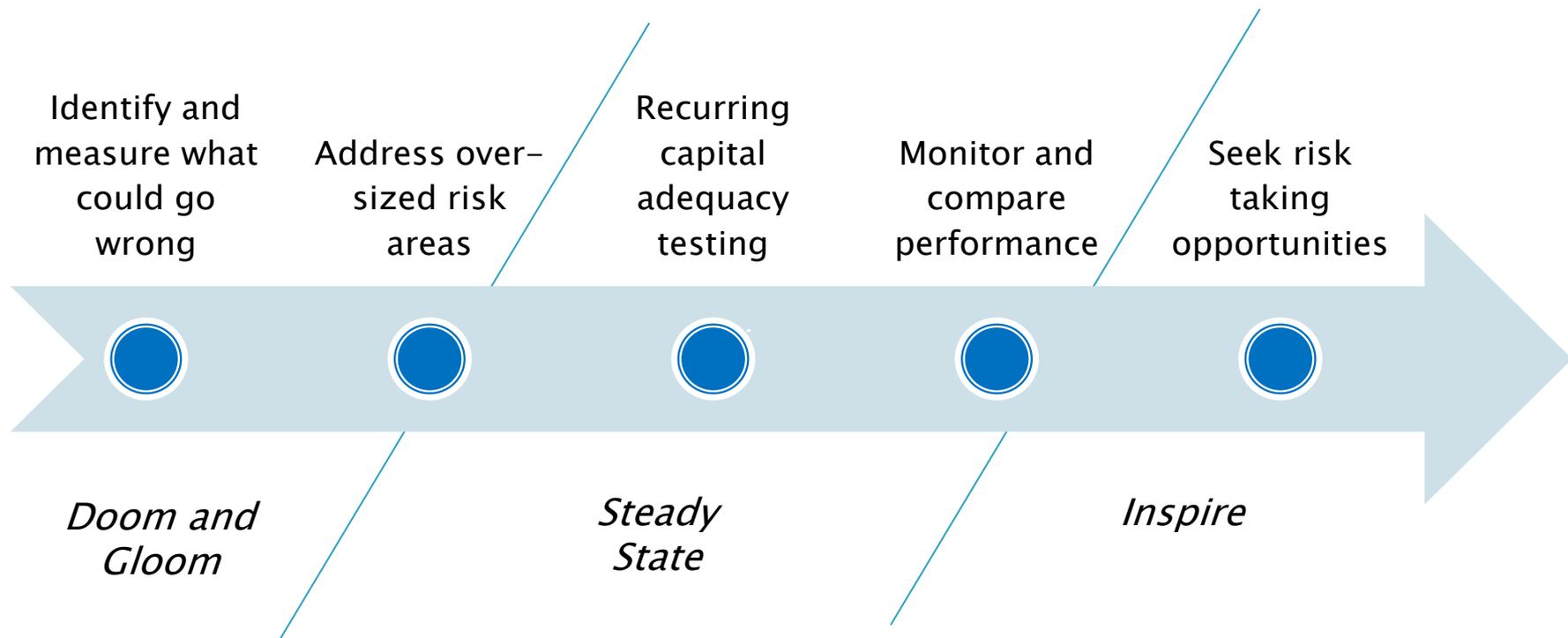
# Economic Capital 101

- ▶ “The amount we could lose if things go worse than expected.”
- ▶ “An amount of surplus we should consider holding to adequately protect against stressful, unexpected outcomes.”

Simulated Capital Amounts



# A typical economic capital journey



“Let thy speech be better than silence, or be silent.”

– *Dionysius of Halicarnassus*  
(60 BC – 7 BC)

# A basic ERM reporting style



# Who's in the conversation?

- ▶ Board of Directors
- ▶ Risk committee of Board
- ▶ Senior management risk committee
- ▶ Senior management team
- ▶ Business leaders
- ▶ ERM liaisons or champions

“Know thy audience.”

– *Probably a quote from somebody*

# When are the conversations?

## ▶ Quarterly

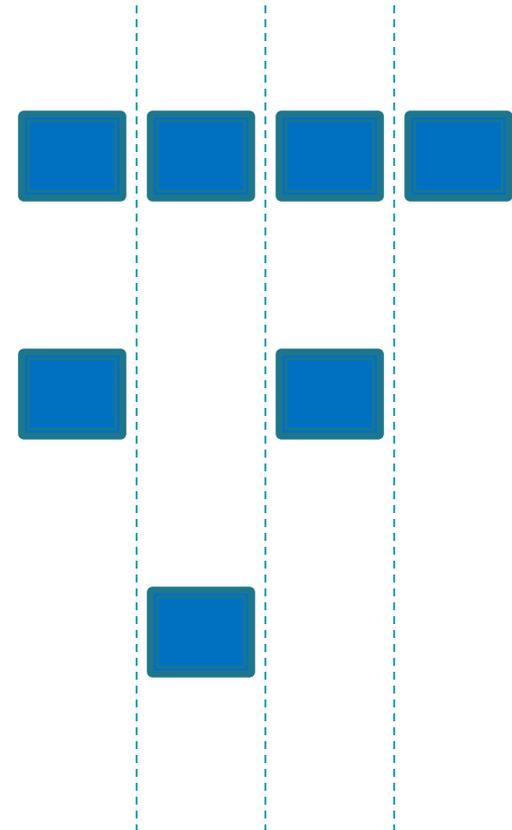
- Key risk indicators
- Capital position report
- Topical risk studies

## ▶ Semi-annually

- Aggregate risk testing
- Risk attribution analysis

## ▶ Annually (ORSA)

- Overview of ERM program
- Review of material risk categories
- Description of changes
- Risk aggregation testing
- Executive “risk framework” review



# Desired outcomes of conversation

## Valuable Up Front Work

1. What reward(s) are we trying to achieve?
  2. Where are we willing to place bets to get there?
  3. How much are we willing to lose to get there?
- 

## Recurring Dialogue

4. How bad could things reasonably get?
  5. Are we comfortable with this possibility?
  6. How much different is the situation than last time?
  7. What caused the change?
  8. Does something need addressed?
- 

## Signs of Maturity

9. How can we trust this information?
10. What should we study that we haven't yet anticipated?
11. Can we achieve our goals more optimally?

# Topic #1 for Company XYZ:

## Risk Profile

### THE REPORT

#### *Risk Profile*

<b>Risk Type</b>	<b>Economic Capital</b>	
	<b>1-in-100</b>	<b>1-in-250</b>
Pricing	\$ 50	\$ 75
Reserving	\$ 40	\$ 100
Catastrophe	\$ 100	\$ 200
Investment	\$ 40	\$ 70
Other	\$ 25	\$ 50
<b>SubTotal</b>	<b>\$ 255</b>	<b>\$ 495</b>
Diversification Effect	\$ (50)	\$ (120)
<b>Total</b>	<b>\$ 205</b>	<b>\$ 375</b>

### TALKING POINTS

- “These categories represent our material sources of risk.”
- “The numbers are estimates of how far results could veer from plan; for instance, there’s an estimated 1% chance a loss of \$205 or more could occur.”
- “Relative to other risk categories, the potential impact of catastrophes is large; this is a critical category to make sure we’re managing appropriately.”
- “These are our best estimates; tail scenarios are difficult to quantify.”
- “We apply model governance procedures to help control the possibility of presenting poor information.”

# Topic #2 for Company XYZ: Risk Growth

## THE REPORT

<i>Risk Growth</i>					
<u>Risk Type</u>	<u>Prior 1-in-100</u>	<u>Current 1-in-100</u>	<u>% Change</u>	<u>Tracking Benchmark</u>	<u>% Change</u>
Pricing	\$ 48	\$ 50	4%	Δ Premium	5%
Reserving	\$ 38	\$ 40	5%	Δ Premium	5%
Catastrophe	\$ 95	\$ 100	5%	Δ TIV	6%
Investment	\$ 35	\$ 40	14%	Δ Invested assets	6%
Other	\$ 24	\$ 25	4%	Δ Surplus	4%
<b>SubTotal</b>	<b>\$ 240</b>	<b>\$ 255</b>	<b>6%</b>	Δ Surplus	4%
Diversification Effect	\$ (54)	\$ (50)	-7%		
<b>Total</b>	<b>\$ 186</b>	<b>\$ 205</b>	<b>10%</b>	Δ Surplus	4%

## TALKING POINTS

- “Overall risk has grown faster than surplus, i.e. 10% versus 4%.”
- “The reason for this seems to be growth in investment risk, which grew twice as fast as its tracking proxy.”
- “After studying the reason for investment risk growth, management is comfortable with the situation and no action is warranted.”
- “The other risk categories have grown as anticipated.”

# Topic #3 for Company XYZ:

## Risk Tolerances

### THE REPORT

#### *Risk Tolerances*

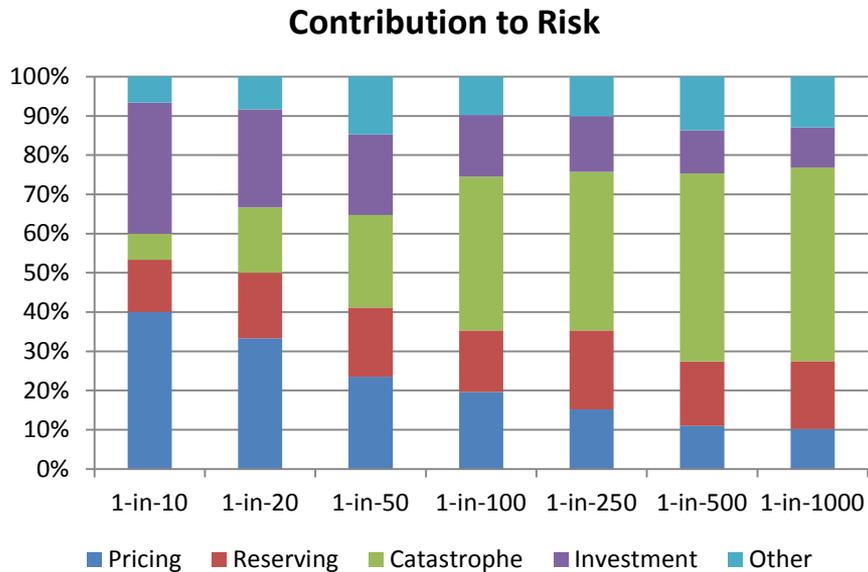
<u>Risk Type</u>	<u>1-in-100 to Surplus Ratio</u>	<u>Ratio Tolerance</u>
Surplus	\$ 800	
Pricing	6%	15%
Reserving	5%	10%
Catastrophe	13%	10%
Investment	5%	10%
Other	3%	5%
<b>SubTotal</b>	<b>32%</b>	<b>75%</b>
Diversification Effect		
<b>Total</b>	<b>26%</b>	<b>50%</b>

### TALKING POINTS

- “Overall risk taking is with well within the established tolerance. When ratio’d to surplus, it’s 26% versus a tolerance of 50%.”
- “Catastrophe risk is outside of its established tolerance and management is studying ways to mitigate the situation.”
- “Investment risk is below established tolerance and management is actively pursuing an increase in risk taking given perceived opportunity.”

# Topic #4 for Company XYZ: Risk Attribution

## THE REPORT



## TALKING POINTS

- “Mitigating ‘risk’ requires different approaches depending on what you’re concerned about.”
- “Risk encountered once or twice a career are more likely to be pricing and investment related.”
- “Extreme risk, which may never be experienced in a career, would more likely be from catastrophes.”

# How's the conversation going?

Favorable Signs	Room to Mature
Less formal presentation, more conversation	Dialogue flows in only one direction
Audience questions are on risk taking and controls	Questions stay focused on ERM procedures and risk model accuracy
Senior management actively participates and presents risk topics	ERM team is sole presenter of risk information
Conversation leads to study of other topics	Conversation always sticks to the script
Rewards and opportunities balance the conversation	Conversation is generally doom and gloom and risk avoidance
Presenters use consistent risk language and analysis	Audience needs to adjust to differing language and style

# Final thoughts about language

- ▶ Words chosen are a huge factor to success – spend time on them
- ▶ Business leaders already have a language – use it
- ▶ ‘Economic capital’ is techno babble (at first) – try other phrases
- ▶ Metaphors can be great – or terrible
- ▶ ‘Risk’ is a blunt word – reducing times said clarifies message
- ▶ Risk taxonomy suffers from lots of dialects – seek consistency

“We have too many high sounding words, and too few actions that correspond with them.”

– *Abigail Adams*  
(1744–1818)