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RATINGS SERVICES**

McGRAW HILL FINANCIAL

# Evaluating Insurers' Enterprise Risk Management Practice

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# Agenda

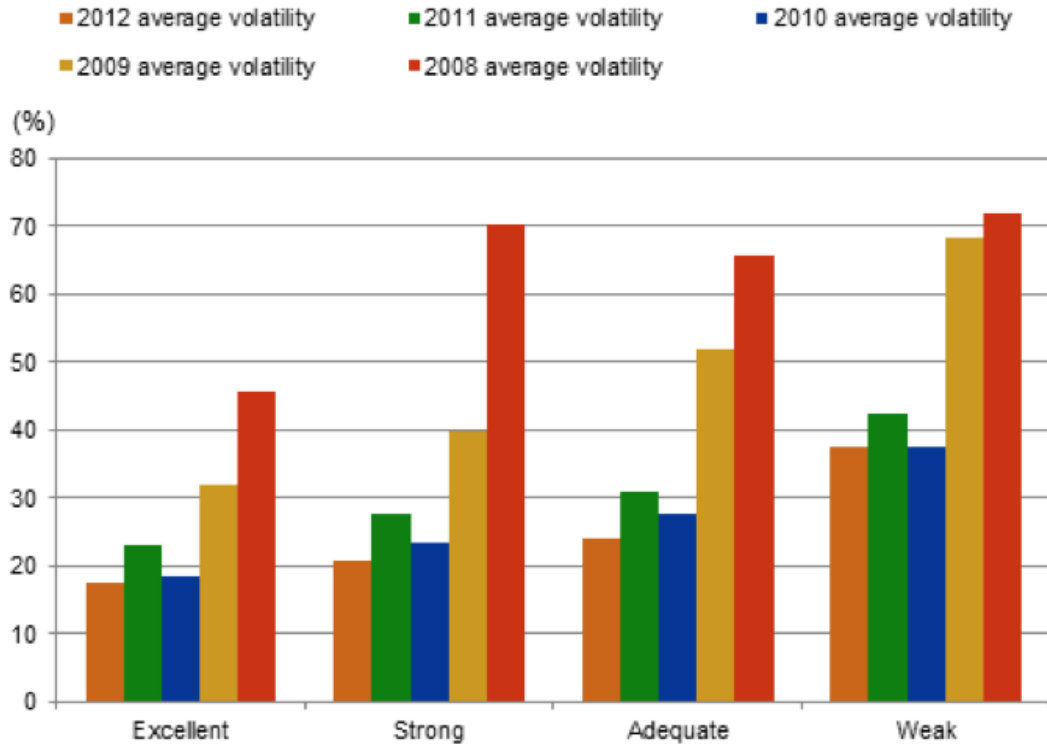
- **Overview of S&P's ERM Evaluation**
  - The Value of ERM
  - Importance of ERM evaluation in the rating process
- **S&P's ERM Evaluation Framework**
- **Insurance Industry ERM Report Card**
  - ERM score distribution
  - Current issues in play for ERM

# Overview of S&P's ERM Evaluation

# The Value of ERM

## Stock Performance Relative to S&P's ERM Scores

Updated ERM Score And Stock Price Volatility\*



\*Price volatility calculated from weekly log normal returns over the past year. Excludes mortgage and title insurers. Source: Standard & Poor's and Capital IQ.

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# Overview of S&P's ERM Evaluation

**S&P's ERM evaluation is:**

- **A component of the rating analysis**
- **Divided into three levels of evaluation**
  - Level I and II
  - Level III (Economic Capital Model Review)
- **A process that's tailored to the insurer's risk profile**
- **An evidence based approach**
- **A perspective view of an insurer's risk profile and capital needs**

ERM examines whether insurers execute risk management practices in a systematic, consistent and strategic manner across the enterprise, which effectively limits future losses within an optimal risk/reward framework.

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# Overview of S&P's ERM Evaluation

- **S&P's ERM Level I and II reviews consist of five subfactors**

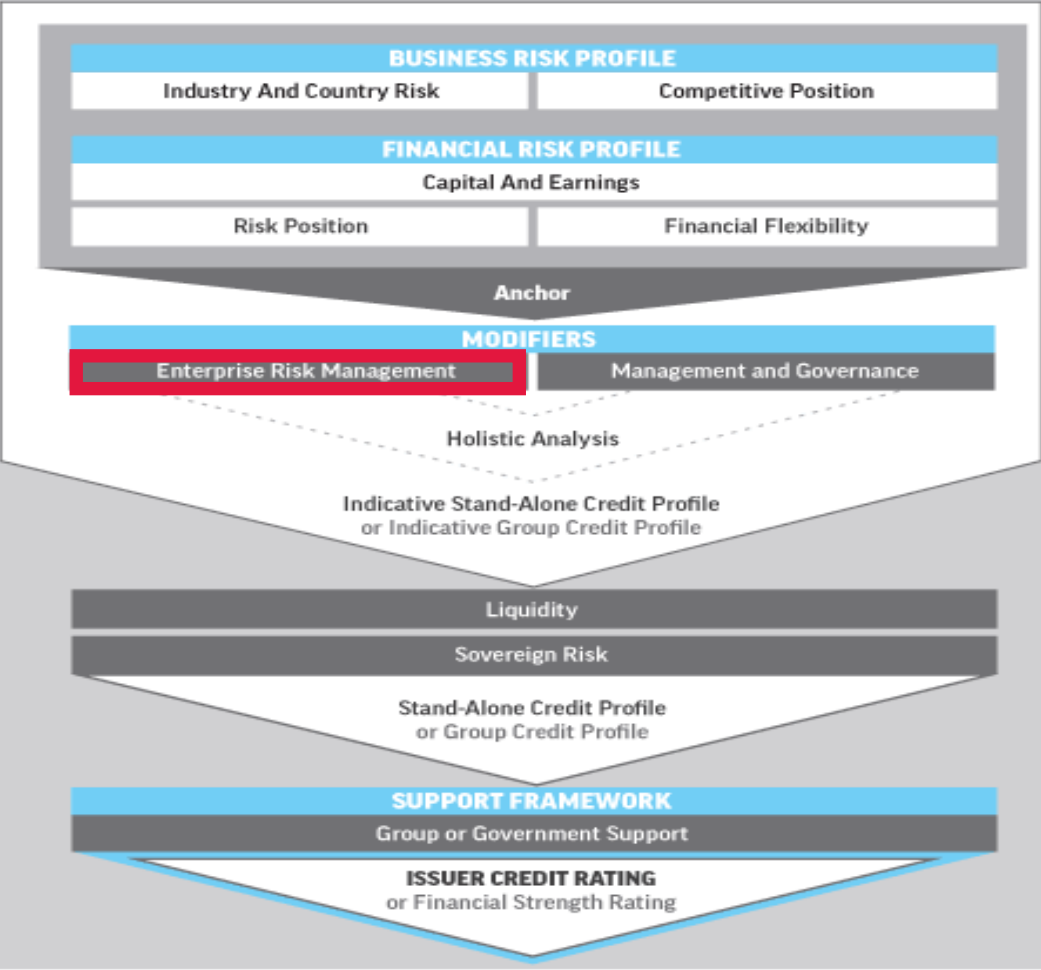


- **ERM Scores Classification**
  - Overall ERM Score: (1) Very Strong, (2) Strong, (3) Adequate w. Strong Risk Controls, (4) Adequate, (5) Weak
  - Each subfactor: (1) Positive, (2) Neutral, (3) Negative

# The Insurance Ratings Framework

## Insurance Ratings Framework

To produce a long-term rating on an operating insurance company, Standard & Poor's assesses eight rating factors, adjusts them in a comparative analysis of peers, and assesses sovereign risk. Lastly, we analyze the potential for the insurer to benefit from extraordinary group or government support.



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# The Importance of ERM In the Rating

- **The importance of ERM to the rating is high for insurers exposed to complex risks that:**
  - Could cause a significant loss of capital and earnings in a short period of time, or
  - Are highly uncertain and usually long term in nature
- **Examples of high importance**
  - Significant exposures to natural catastrophes, volatility of reserves for long-tail casualty business, or financial market volatility
- **Examples of low importance**
  - No significant exposure to these types of risk or regularly retains excess capital relative to risk



# The Importance of ERM In the Rating

**Table 13: Indicative SACP or GCP Assessment**

Anchor (from Table 1)	ERM and management assessment (from Table 14)				
	Very strong	Strong	Adequate	Less than Adequate	Weak
aa+	aa+	aa+	aa-	a	bbb
aa	aa	aa	aa-	a	bbb
aa-	aa-	aa-	a+	a	bbb
a+	a+	a+	a+	a-	bbb-
a	a+	a	a	a-	bbb-
a-	a	a-	a-	bbb+	bbb-
bbb+	a-	bbb+	bbb+	bbb	bb+
bbb	bbb+	bbb	bbb	bbb-	bb+
bbb-	bbb	bbb-	bbb-	bb+	bb
bb+	bbb-	bb+	bb+	bb	bb-
bb	bb+	bb	bb	bb-	b+
bb-	bb	bb-	bb-	b+	b
b+	bb-	b+	b+	b	b-
b	b+	b	b	b-	b-
b-	b	b-	b-	b-	b-

# S&P's ERM Evaluation Framework

# Elements of S&P's ERM Evaluation



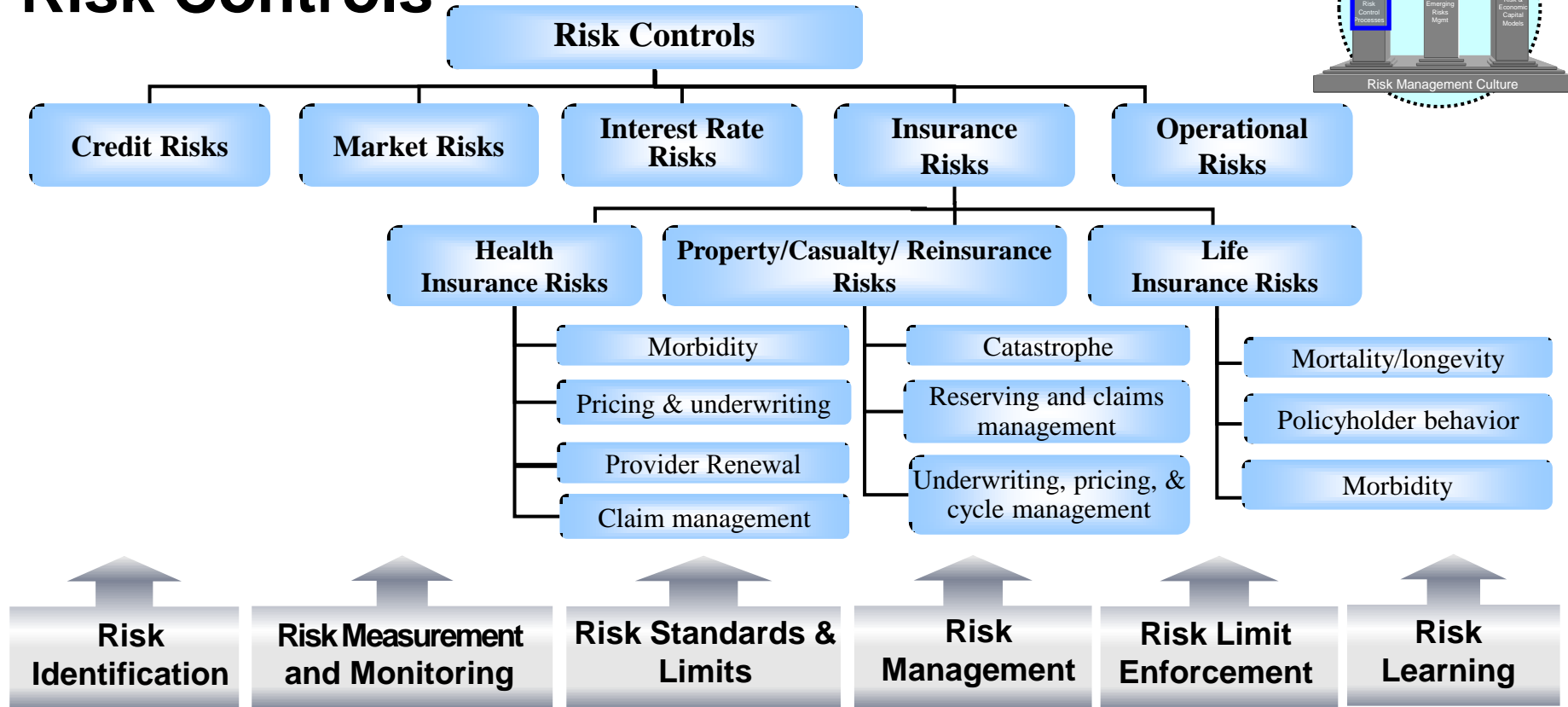
## Risk Management Culture

- Risk governance and organization structure
- Risk appetite framework
- Risk reporting and communication
- Incentive compensation structures

The Risk Management Culture subfactor focuses on the importance placed on risk and ERM in all key aspects of the insurer's business operation and corporate decision-making.

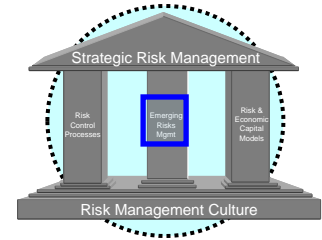
# Elements of S&P's ERM Evaluation

## Risk Controls



The Risk Controls subfactor focuses on the importance given to risk and ERM in all key aspects of the insurer's business operation and corporate decision-making

# Elements of S&P's ERM Evaluation



## Emerging Risk Management

- Risk Identification
- Risk measuring and monitoring
- Risk prioritizing
- Management's response

The Emerging Risk Management subfactor analyzes how the insurer addresses risks that are not a current threat to creditworthiness, but could become a threat in the future. It assesses the insurer's level of preparedness if those emerging risks materialize.

# Elements of S&P's ERM Evaluation



## Emerging Risk Management

### Positive

The insurer has well-established processes for identifying and monitoring emerging risks, analyzing their significance, and preparing for and/or potentially mitigating them.

### Neutral

The insurer has some processes in place to identify and analyze the impact of emerging risks; but these processes are more ad-hoc and don't lead to risk mitigations.

### Negative

The insurer doesn't have processes for identifying and evaluating emerging risks.

The Emerging Risk Management subfactor analyzes how the insurer addresses risks that are not a current threat to creditworthiness, but could become a threat in the future. It assesses the insurer's level of preparedness if those emerging risks materialize.

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# Elements of S&P's ERM Evaluation

## Emerging Risk Management – Informative Evidence



- Evidence that the insurer has a structured process to identify risks that could emerge as threats to continuing growth and success
- Evidence that such processes are performed regularly
- Documentation of well-established processes for assessing, addressing, and mitigating the threat of each potential emerging risk
- Evidence that such processes involve quantifying, whenever possible, the impact through stress testing and scenario analysis
- Evidence that mitigating processes, when possible, are implemented in anticipation of the potential contingency, not as a result of its occurrence
- Evidence that the insurer performs thorough post-mortem analyses of past problems and feeds the results of such analysis into its ERM process

# Elements of S&P's ERM Evaluation



## Risk Models

- **Robustness, consistency, completeness**
- **Model governance and validation**
- **Methodology/assumptions/data**
- **Incorporation of results in decision making processes**
- **Economic capital model**

The Risk Model Subfactor focuses on assessing the robustness, consistency, and completeness of the insurer's risk models.



# Elements of S&P's ERM Evaluation



## Strategic Risk Management

- Use of model results
- Prioritization of strategic options
- Optimization of risk-adjusted returns
- Key areas of analysis

Strategic  
Planning

Product  
Pricing

Strategic Asset  
Allocation

M&A/ New  
Market Entry

Reinsurance/Hedging  
Strategy

Capital/ Economic  
Capital Allocation

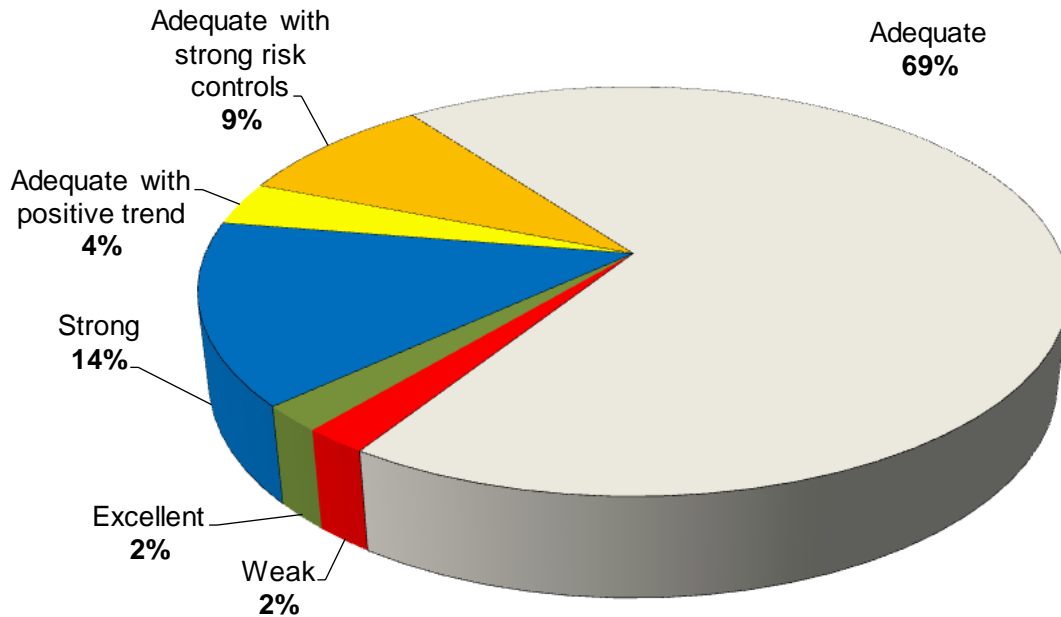
Risk-adjusted  
Return Optimization

The Strategic Risk Management subfactor assesses the insurer's program to optimize risk-adjusted returns and to evaluate and prioritize strategic options on a level playing field.

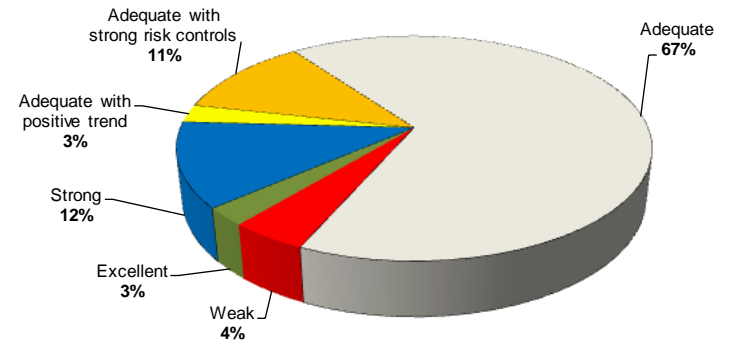
# ERM Report Card

# ERM Scores For North American and Bermudian Insurers

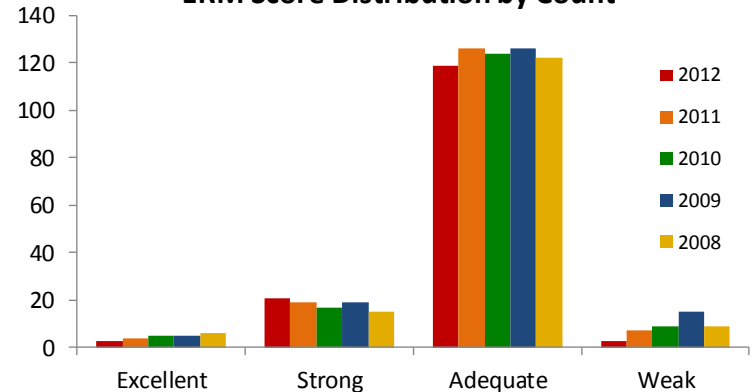
As of Dec 31, 2012, 146 companies



As of Dec 31, 2011, 156 companies



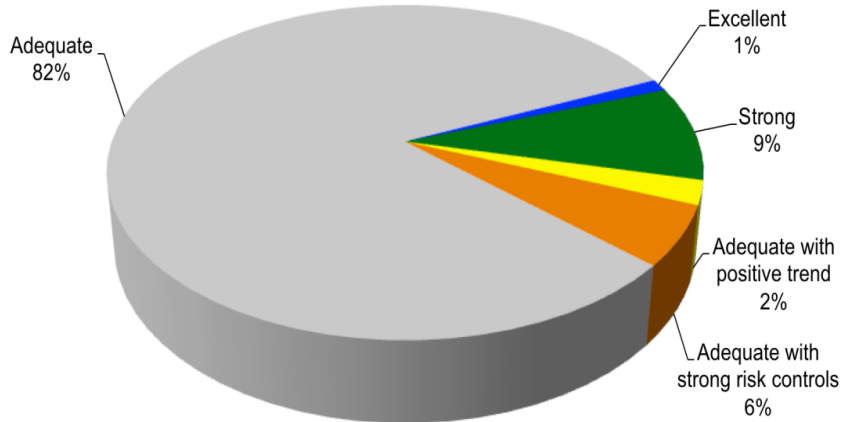
ERM Score Distribution by Count



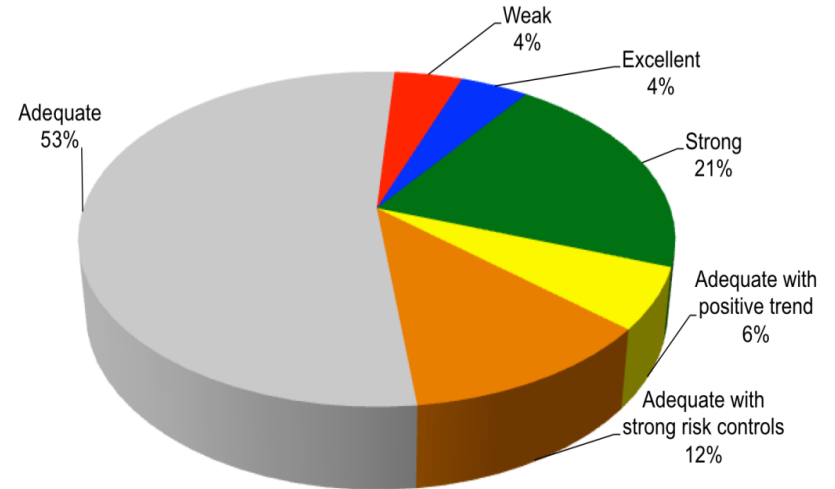
“Note: “Excellent” and “Adequate with positive trend” were ERM score categories at yearend 2012. They are no longer ERM score categories per S&P’s Enterprise Risk Management Criteria (May 7, 2013).

# ERM Score: P&C vs. Life & Health

## ERM Scores for Life & Health (including Multi-line) Insurers

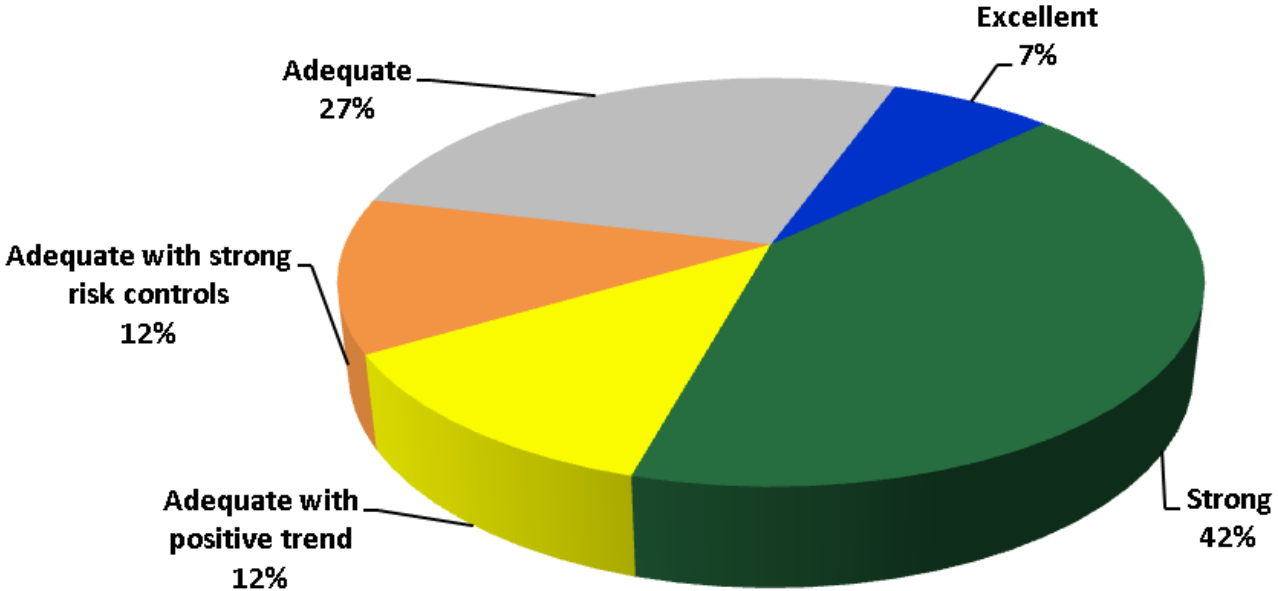


## ERM Scores for P&C (including Multi-line) Insurers



# ERM Level II Scores

Based on 41 companies as of yearend 2012



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# Current Issues In Play For ERM

- **Risk Management Culture**
  - ERM governance structure; Risk appetite framework
- **Risk Controls**
  - Market risk: variable annuity products and hedge programs
  - Credit risk: ‘de-risking’ or ‘re-risking’
  - Interest rate risk: sustained low interest rate / interest rate spikes
  - P&C insurance risk: catastrophic losses
  - Life insurance risk: mortality/longevity/policyholder behavior
  - Operational risk
- **Risk Models**
  - Stress testing
  - Economic Capital Model
- **Regulatory Changes**
  - Solvency II / ORSA preparedness

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# References

- Criteria | Insurance | General: Enterprise Risk Management, May 7, 2013
- Criteria | Insurance | General: Insurers: Rating Methodology,, May 7, 2013
- Criteria | Insurance | General: A New Level Of Enterprise Risk Management Analysis: Methodology For Assessing Insurers' Economic Capital Models, Jan. 24, 2011
- Credit FAQ: What Informative Evidence Does Standard & Poor's Use In Its Updated Enterprise Risk Management Analysis? May 8, 2013
- Process Improvements And Regulation Drive ERM Of North American And Bermudian Insurers Forward, April 18, 2013
- Additional Resources:
  - [www.standardandpoors.com](http://www.standardandpoors.com)
  - [www.globalcreditportal.com](http://www.globalcreditportal.com)



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# Thank You

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