



# ERM Practices and

*The rating agencies' new focus on enterprise risk management emphasizes consumers and policyholders. Companies adopting or adapting risk management practices, however, can't afford to lose sight of the shareholders.*

BY RICHARD GOLDFARB

**IN RESPONSE TO GROWING CONCERNS** about risk management practices within the life and property/casualty insurance industries, several rating agencies have recently announced plans to add an enterprise risk management (ERM) assessment to their insurer rating process. Standard & Poor's (S&P) first announced its intentions last fall and by early spring had conducted nearly 80 ERM reviews for the 2006 rating cycle. Other rating agencies, including A.M. Best, Moody's, and Fitch, have also signaled their intent to focus on ERM, though they've been less specific than S&P with regard to their specific approach.

The rating agencies' focus on enterprise risk management is a positive development for the industry and will formalize the risk management culture that many insurers have already been adopting. Further, this development is expected to strengthen the role of the chief risk officer (CRO) and improve the CRO's

ability to fund important but idle risk management projects.

As with any new management process, the challenge will be for companies to quickly identify industry best practices and ensure that any new processes, new information sources, and new systems put in place are both effective and value-enhancing for their firms.

Some insurers are well on their way down this path but have followed a different approach from what rating agencies may be expecting. For these insurers, the key challenge will be to effectively communicate the value of their approach and its appropriateness to their specific company. For insurers that intend merely to adopt the processes described by the rating agencies (assuming they're reasonably consistent), the challenge will be to ensure that the rating agency view is appropriate for their organization.



# the Rating Agencies

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In many instances, the rating agencies' approaches contain an inherent bias toward the concerns of policyholders and debt holders. This bias is appropriate, given their objective of establishing credit ratings, but it may limit how useful an agency's specific framework might be as a tool to guide management decisions aimed at maximizing shareholder value.

## **S&P's ERM Assessment**

While all the rating agencies are moving to adopt ERM assessment procedures, S&P has provided the greatest amount of detail about its approach and the ERM practices it expects to see in the companies it reviews. Therefore, our discussion focuses entirely on the S&P ERM framework, although many of the observations are likely to apply to the other rating agencies as well.

**Role in overall rating.** The first thing to note about S&P's ERM assessment is that it's not intended to serve as a replacement for any of the agency's current ratings review practices. In particular, it's not a replacement for S&P's existing capital adequacy testing, even though the term "ERM" is often interpreted as a form of *enterprisewide capital modeling*. Instead, S&P views its new ERM assessment as an extension of the procedures it uses to assess the strength of an insurer's management team, business plan, and strategy. In essence, this is just another dimension of a process that already reflects a multifaceted review of an insurer's current and prospective financial strength.

**View of ERM.** S&P defines *risk management* as the process companies use to identify and monitor significant risks and to set limits for these risks that reflect their risk appetite, compe-

tencies, and resources. *Enterprise risk management* extends these core risk management processes so they can be adopted consistently across all risks and in a way that supports the company's overall corporate strategy.

### Critical Priorities for Insurers

S&P expects its perspective on industry "best practices" to evolve as it completes more detailed reviews of a wider array of insurers. Further, it hopes to see more insurers presenting their own ERM frameworks, as opposed to simply adopting the process S&P has proposed. This will suggest that the process was chosen because of its ability to guide the management of the firm and not simply to comply with a perceived requirement.

That said, ERM assessments are new for the S&P analysts. To the extent that a particular company's approach deviates significantly from the framework set forth by S&P, the analysts' ability to fairly assess alternative approaches may be limited. Therefore, it's useful to explore the five key components of the framework in greater depth and examine some of the challenges insurers may face in preparing for S&P's ERM review.

**Risk management culture.** The guidelines released by S&P indicate a strong expectation of a highly qualified, effective, and centralized risk management department. Furthermore, there is an expectation that the firm's structure will be "indicative of a high degree of influence on decision-making by risk management staff." For many companies, this type of centralized and

powerful risk management department, perhaps headed by a chief risk officer, may be appropriate. Even for those companies, however, the implied involvement of the CRO in line decision-making may not be desirable for what is principally a policy-setting and monitoring staff function.

But for other insurers, particularly the smaller ones, it may be more effective to ensure that everyone is part of the risk management staff. Since the assumption of risk and the management of that risk are the two core elements of all insurance company activities, this decentralized approach may even be preferable. Certainly, it's more consistent with the notion of fostering a high degree of risk awareness throughout the company, perhaps the Holy Grail of ERM advocates.

Nonetheless, some degree of centralization may be important to ensure that clear and widely known risk management policies, procedures, and objectives are communicated throughout the organization. In addition, in risk-taking organizations it's often advantageous to ensure that the processes of risk measurement and monitoring are independent from risk taking and management.

**Risk control processes.** The primary components of the evaluation of a company's risk control process include the quality of its methods and processes for identifying, measuring, and monitoring the risks it assumes. For most insurers, these are already core functions and should not create any new issues. There are, however, two components of the S&P definition of risk control processes that some firms may need to address more fully.

## Key Components in S&P's ERM Assessment

- ★ **RISK MANAGEMENT CULTURE.** S&P will assess the degree to which a company incorporates risk management into its business decisions and how much importance the company places on financial strength, the risk of insolvency, and earnings volatility.
- ★ **RISK CONTROL PROCESSES.** S&P will evaluate the effectiveness of risk control processes for all the major risk components, including market risk, credit risk, insurance risk, and operational risk.
- ★ **EXTREME EVENT MANAGEMENT.** S&P is concerned about the impact of low-frequency events, since these are more difficult to manage through controls. In particular, it's interested in the degree to which insurers anticipate extreme events, measure their impact, and prepare responses to those events.
- ★ **RISK MODELS AND CAPITAL MODELS.** S&P will review the models companies use to measure specific risks, as well as the capital models used to assess their overall financial strength. S&P will be especially concerned with whether the models produce measures that are useful for company management.
- ★ **STRATEGIC RISK MANAGEMENT.** S&P views this aspect as encompassing all ways in which risk is embedded into managerial decision-making and the extent to which those decisions are driven by an assessment of the trade-offs between risk and potential profits (reward).

First, S&P is particularly concerned with the methods firms use to establish and enforce *risk limits*. This focus is understandable, in light of property/casualty carriers' 2005 hurricane experience and life insurers' growing exposure to equity and interest-rate risks in variable annuity products containing embedded options. However, many companies lack sound practices for establishing risk limits. Many more lack the systems needed to monitor and enforce the risk limits they've set.

More challenging, though, is the philosophy—suggested in S&P's definition of ERM as incorporating risk management functions that are consistent with the company's strategy—that the insurer's risk limits in specific areas should be consistent with an overall corporate *risk appetite* or *risk tolerance*. These are vague concepts that are often defined quite differently. At the moment, it appears that few companies have defined their risk appetite. Those that have seem focused solely on capital adequacy measures. The links between risk appetite and risk-taking limits seem weak, at best.

A sensible definition of risk appetite should reflect the firm's view of the appropriate trade-off between risk and reward. For a risk-taking entity such as an insurer, the concept of enforced risk limits that don't explicitly reflect the potential reward for assuming risk is unlikely to promote optimal behavior by those charged with accepting or rejecting new insurance risks.

Furthermore, S&P is interested in documentation of the *effectiveness* of risk avoidance and risk mitigation strategies, such as risk transfer through hedging, securitization, or reinsurance. Insurers' ability to document effectiveness may be more limited than S&P has acknowledged. That's because it's difficult to determine the effectiveness of those strategies based on a single outcome and even harder for companies to fully quantify how different strategies may have compared with the strategies they actually adopted. For example, while it seems reasonable to argue that insurers hit particularly hard by Katrina-related claims may have found purchasing more reinsurance before the hurricane to be more "effective," this assessment can't fairly be made without considering what reinsurance would have been available at that time and at what cost.

S&P has indicated that a primary goal of ERM is to make sure that insurers are making appropriate risk-reward trade-offs. Obviously, the effectiveness of risk mitigation strategies can't be fairly assessed based solely on realized results. Instead, the focus will need to be placed on:

- Evaluating the risk evaluation process;
- Assessing the degree to which companies have considered the potential impact of alternative strategies on risk and returns;
- Testing the degree to which risk mitigation strategies performed as expected.

**Extreme event management.** S&P wants insurers to demonstrate various forms of environmental scanning and scenario planning to anticipate low-frequency events and to test their financial impact. This approach is consistent with the operational risk management practices being incorporated into various regulatory capital regimes in the United Kingdom, Switzerland, and the European Union.

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However, the S&P framework astutely recognizes that merely holding capital to fund the financial consequences of extreme events isn't the most effective way to manage these sorts of risks. Instead, companies need to place greater emphasis on establishing processes that help to *prepare a response* to these events. Contingency planning and crisis response, particularly with respect to financial liquidity, are critical risk management actions that companies can and should adopt well in advance of actual events.

Just as important, though, S&P is interested in hearing from companies about how past events have resulted in revised business practices and what lessons they learned from those events.

**Risk models and capital models.** As noted earlier, S&P's ERM assessment framework is not intended to replace its current approach to testing insurers' capital adequacy. As a result, its interest in firms' risk models and their capital models isn't intended to reflect an adoption of internal capital models in place of S&P's existing capital adequacy formulas.

This has confused some insurers, in part because regulators in the United Kingdom, Switzerland, and the European Union are, in fact, encouraging firms to develop their own internal capital adequacy models, which will be subject to regulatory review to ensure consistency with certain core principles.

S&P's focus is different. It wants to ensure that companies are measuring risk in their business so they can use the information

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to guide the decisions being made. S&P is less interested in the model results per se, at least for now.

This focus on using the models to guide decisions explains why S&P's model review emphasizes the efficiency of the models, how quickly assumptions can be altered, how data are updated, and how appropriate the models and assumptions are for critical business decisions.

Nonetheless, one potentially challenging aspect of S&P's intended model review is its apparent emphasis on *risk capital* as a "vital" component of strategic risk management. As used in this context, risk capital reflects a specific type of risk measurement. Under this approach, an insurer determines the total capital needed to ensure a specific probability of satisfying current policyholder obligations. It then allocates this capital to specific businesses, activities, or products in relationship to their relative contribution to the total risk of the firm.

References to this particular type of risk model have led many firms to make the creation of a risk capital model a top priority. For several reasons, however, it remains unclear whether this is an appropriate reaction. One reason is that, despite the language used in its public pronouncements on the subject, S&P doesn't intend to suggest any particular method of incorporating risk into insurers' management decisions. Its statements on the subject simply reflect how some companies have attempted to achieve this objective.

A second reason why risk capital models should perhaps not be a top priority is that these models, as currently used by many companies and as intended to be used for regulatory purposes, tends to focus on risk from a policyholder's perspective, not a shareholder's perspective. It's unclear whether these models actually produce the information insurers need to make "better" or more value-enhancing decisions for their shareholders. These policyholder- or "solvency"-focused models often ignore the risk events that could more immediately harm the shareholders, such as a ratings downgrade or a need to raise external capital that's dilutive to the current shareholders. Finally, numerous theoretical and practical issues limit insurers' ability to allocate risk capital to the fine level at which ac-

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tual risk-based decisions need to be made.

**Strategic risk management.** S&P's ultimate goal is to see insurers make risk considerations a critical factor in their tactical and strategic decisions. As noted, S&P's public statements suggest a strong focus on *risk capital* as the primary means to achieve this goal. Whether insurers actually adopt this approach or not, it's clear they'll need to demonstrate their consideration of risk in a variety of decision processes.

For insurers, product pricing is the primary risk management activity. This is where the greatest opportunity exists to manage the risk explicitly assumed through policy issuance and to seek an appropriate risk-reward balance. It's clear that insurers need a risk-based pricing methodology and that this methodology will be subject to S&P's review, regardless of whether or not risk capital plays a vital role in this process.

In other areas, such as portfolio management, capital budgeting, and risk-adjusted performance assessment, insurers are likely to explore numerous methods to reflect risk and to better inform the decision-making process. It's not yet clear whether one particular approach will emerge as being the most useful for these purposes. But failing to adequately consider risks in decision-making is clearly no longer an option for insurers.

## A New Journey

The focus that S&P, A.M. Best, Moody's, and Fitch have recently placed on enterprise risk management largely reflects that the better-managed insurers have already adopted some or all of these practices. But many insurers will begin a new journey as they face the challenge of adopting new processes and methods.

As insurers begin to move down this path, they'll need to recognize that this is an uncharted journey for which no clear guidelines have yet been established. The S&P framework reflects one view of how the goal of effective risk management can be achieved. But since the agency's approach isn't driven by concern for shareholders, it remains unclear whether S&P's suggested priorities or methods, particularly those related to the use of *risk capital* to guide strategic risk management, will enhance shareholder value.

Regardless of the specific steps that individual companies will take as they move to adopt enterprise risk management, the rating agencies' new focus on ERM reinforces its status as a vital discipline that deserves the attention of all insurance companies.

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