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Standard & Poor's Enterprise Risk Management Evaluation of Insurers

by David N. Ingram

In October 2005, Standard & Poor's Ratings Services announced a new addition to the analysis process that leads to the ratings of insurers: Enterprise Risk Management (ERM) evaluation criteria.

Within the evaluation of ERM capabilities, Standard & Poor's will primarily be looking at how management of an insurer defines the loss tolerance of the firm and the processes that are being performed to assure that losses experienced by the insurer are kept within that loss tolerance. In addition, the ERM evaluation will focus on the degree to which insurer management views risk and return for risk-taking in setting corporate direction and in strategic decision-making.

The ERM evaluation will primarily be a subjective view of quality of management practices. The focus will be to look for practices that are being carried out in a systematic and consistent way that will lead to the control of future losses in a predictable manner and that will lead to an optimal risk/reward structure for the insurer's businesses. The ERM practices will be viewed in comparison to the risks of the company and to the practices of peer companies with similar risks. Standard & Poor's will look for sophisticated risk-management practices to deal with sophisticated risks.

Insurers will be viewed as having "excellent," "strong," "adequate" or "weak" ERM.

To reach those views, Standard & Poor's will evaluate ERM quality in five areas:

I. Risk Management Culture

Risk management culture is the degree to which risk and risk management are important considerations in the everyday aspects of corporate decision-making. To evaluate risk management culture, Standard & Poor's will look at the staffing and organizational structure of the people who are charged with executing the risk management function in the insurer. The governance structure as it relates to risk management is another aspect of risk-management culture. A favorable indicator of risk-management culture is a structure that is indicative of a high degree of influence on decision-making by risk management staff. Communication of risk and risk management—both inside and outside of the insurer—are also indicators of risk-management culture. An insurer with a strong risk management culture will have a very transparent risk management process within the company and with other interested parties through their public communications.

II. Risk Controls

Risk control is achieved through identifying, measuring and monitoring risks as well as by setting and enforcing risk limits and managing risks to meet those limits through risk avoidance, risk transfer and risk offset or other risk-management processes. Standard & Poor's will evaluate risk-control processes for each of the important risks of an insurer. Consistency between the overall corporate risk tolerances and the specific risk limits will be an important consideration. Summary descriptions of risk-control programs as well as examples of actual execution will be reviewed. Standard & Poor's will be looking for insurers that have programs that are structured to effectively deliver the risk control needed to maintain the exposures and losses within the risk tolerances as well as consistent execution of those programs that is sufficiently embedded in everyday practices that future execution can be reliably inferred.

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III. Extreme Risk Management

Extreme-event risk management is concerned with the impact of low frequency adverse events on the company. Low frequency events cannot easily be managed via a control process because the monitoring is not expected to show any results in most periods. Common extreme event risk control practices include trend analysis, stress testing, contingency planning, problem post mortem and risk transfer. Standard & Poor's will be looking for insurers to show that they are practicing extreme risk management in advance of problem events and will also be looking for the results of effective extreme event risk management during and after adverse events. Those results will include prompt information on the exposure of the insurer to loss from the actual event, prompt and surefooted insurer response to the event, losses that are moderated in some fashion, and a clear set of lessons learned and adjustments to future procedures.

IV. Risk and Economic Capital Models

Risk and economic capital models are an important part of ERM. Effective flow of information about risk positions and their possible impact on the insurer are key to effective risk management. Standard & Poor's assesses the risk models of an insurer in relation to the risks of the insurer and to the processes that the insurer has to use the information from the risk models. An insurer with effective risk models will be able to show that the models produce the information needed to perform the basic risk-control functions that are needed to sustain losses to within their risk tolerances. This means that the risk models need to produce information that is sufficiently accurate, up-to-date and timely to drive correct and well-timed risk-management decisions and actions. These models need to be clearly understood by management. The insurer needs to demonstrate a regular process of model validation as well as a process for updating data about the business activity being modeled and the assumptions that are used in the model. The model needs to be sufficiently robust to produce insight into all of the risks that are retained as well as the risks that are written but not retained. The models need to provide information that is both descriptive of the size of the risk and information that is actionable in managing the risks. If those two different objectives are met by different models, then the two models need to be reconciled regularly.

To accomplish strategic risk management, insurers need to determine the risk capital that is associated with their products, investments and operations. Evaluation of an insurer's processes for developing risk capital involves looking at the underlying assumptions, data flows, validation and calculation processes. Insurers that use regulatory or rating agency risk-based capital formulas without modification will be pressed to demonstrate that those models appropriately capture the actual risks of their specific business. Insurers that modify those formulas in an appropriate manner to reasonably approximate the capital needed to support their risk positions are seen to have adequate practice in this area. Economic capital models are sophisticated and detailed models that produce spot values for capital needs, often linked closely to specific market values on the exact day of the calculation. For very complex risks, economic capital models might be the only manner of reasonably identifying capital needs.

At this point, Standard & Poor's will be looking for appropriate processes to develop risk capital amounts that are consistent with the insurer's risks and risk-management programs, that have an update and validation process that produces a result that is consistent with the intent of the insurer, and that are produced on a schedule that will support usage in the insurer's strategic risk-management processes.

Standard & Poor's will be continuing to develop robust processes of evaluating insurers' Economic Capital processes so as to better inform our overall view of the financial strength and capitalization in particular. This review will only be performed for companies that are found to have effective and coordinated processes for risk control, business continuity, risk management culture, and risk models.

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> "As ERM becomes the mantra for today's insurance organizations, companies can fail to assess the real impact of reinsurance in the ERM integration process."

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V. Strategic Risk Management

Strategic risk management is the process that an insurer uses to incorporate the ideas of risk, risk management and return for risk into the corporate strategic decision-making processes. Risk capital is usually a key concept in these processes. Standard & Poor's analysis of strategic risk management will start with understanding the risk profile of the insurer and getting management explanation of the reasons for recent past changes in the risk profile as well as expected future changes. Risk profile can be expressed in terms of risk capital for various risks or for each of the businesses of the insurer. Insurers might also be able to express an understanding of the sensitivities of that risk profile to the time view and the loss tolerance of the metric used. Standard & Poor's looks at the method used for the allocation of any diversification benefit that is incorporated into the risk profile and the impact of the allocation choice on the strategic decisions made using the risk capital.

Strategic processes that could be affected by risk and risk management thinking include capital budgeting, strategic asset allocation, product risk/reward standards, risk-adjusted financial targets, and performance measurement, dividend practices and incentive compensation. The degree to which risk capital is vital to these processes and to which risk and risk management are a consideration on these process is indicative of the quality of strategic risk management.

Concluding Remarks

The evaluations of each of these five areas will be combined into a single classification of quality of ERM. The degree of importance of each factor in that judgment will vary on an individual basis among insurers according to the specific situation of the insurer. (See Table 1 on page 17).

The importance of ERM in that process will depend on the risks of the insurer and the capacity of the insurer to absorb losses. For an insurer with a high capital position and/or excellent access to capital and a business plan that concentrates on retaining only those risks that are less complex and well understood by the company, ERM will be less important in forming the rating decision. For insurers with tight capital and/or limited access to capital that are exposed to very complex risks, ERM will be a very important part of the rating decision. However, capital is not seen as a substitute for ERM. A company with a high capital position still needs to be able to demonstrate that it has the ability to maintain that position through limiting future losses. In addition, Standard & Poor's will continue to view an insurer with more capital to be more secure than an insurer with less capital. ✦

Table 1: Definitions of ERM Classifications

Classifications	Definition
Excellent	Insurer has extremely strong capabilities to consistently identify, measure and manage risk exposures and losses within the company's predetermined tolerance guidelines. There is consistent evidence of the enterprise's practice of optimizing risk-adjusted returns. Risk and risk management are always important considerations in the insurer's corporate decision-making.
Strong	Insurer has strong capabilities to consistently identify, measure and manage risk exposures and losses within the enterprise's predetermined tolerance guidelines. A strong ERM insurer is somewhat more likely to experience unexpected losses that are outside of its tolerance level than is an excellent ERM insurer. There is some evidence of the enterprise's practice of optimizing risk-adjusted returns, though it is not as well developed as those of leading industry practitioners. Risk and risk management are usually important considerations in the insurer's corporate decision-making.
Adequate	Insurer has capabilities to identify, measure and manage most major risk exposures and losses, but the process has not been comprehensively extended to all significant risks facing the enterprise. Insurer loss/risk tolerance guidelines are less developed. Execution of its existing risk-management programs is sufficient, albeit less comprehensive, than are strong and excellent ERM practices. Unexpected losses are more likely to occur, especially in areas beyond the scope of the existing ERM practices. Risk and risk management are often important considerations in the insurer's corporate decision-making.
Weak	Insurer has limited capabilities to consistently identify, measure and manage risk exposures across the company and, thereby, limit losses. Execution of its risk-management program is sporadic, and losses cannot be expected to be limited in accordance with a set of predetermined risk/loss tolerance guidelines. Risk and risk management are sometimes considered in the insurer's corporate decision-making. Business managers have yet to adopt a risk management framework, are satisfying regulatory minimums without regularly applying risk management to their business decisions, or have very recently adopted a risk management system that has yet to be tested.