

A.M. Best Comments on Enterprise Risk Management and Capital Models

Risk management and capital modeling has evolved as the risk environment of the insurance industry has continued to evolve. Enterprise Risk Management is the broad description of the further integration of risk management across an organization's operations – incorporating the assessment and monitoring of investment, underwriting, operational and reputation risks – along with greater sophistication in the modeling of the organization's risk.

Modeling tools, such as Dynamic Financial Analysis (DFA) and many other risk-based stochastic capital modeling "tools," have been around the insurance industry for more than 10 years but until recently have not generated broad interest. Several stumbling blocks have been the amount of data required to effectively run the model; a fragmented or silo approach to risk management; difficulty in addressing the correlation of risk; and questions over what to do with the model output. Additionally, the focus of the insurance industry has been centered largely on the basics of cycle management, underwriting, claims management and asset management. However, more recently, interest in the topic of risk management and the use of more sophisticated capital modeling tools has been on the rise. Companies increasingly are asking the questions: What is our aggregate risk profile, what are our most significant individual risks, what are we doing to manage and/or mitigate these risks, and are we being compensated for the risks we are taking?

Significant events over the past few years have helped to underscore the importance of work related to these dynamic "black box" models that require so much data and so much effort. The impact of huge losses in the property/casualty sector related to terrorism, more severe and frequent hurricanes, and

ongoing asbestos losses, as well as the increased volatility of the investment markets and corporate governance failures, have raised the importance of risk management and placed a premium on gathering and evaluating the most critical information related to risk management at the enterprise level. Through this accumulation and management of information related to the risk, companies are able to utilize more sophisticated capital models that provide an aggregated view of the risk inherent in their operations.

- Increased focus on Enterprise Risk Management in the rating analysis
- Output from company models will be considered in the rating analysis and could change A.M. Best's view of the company's capitalization
- BCAR is still the starting point for A.M. Best's assessment of capitalization
- BCAR provides a consistent baseline for analysis

A.M. Best expects the risk-management process and capital modeling tools to continue to evolve as more data are collected and additional information is obtained through the analysis of the collected data. The use of risk modeling itself provides additional information that will be used in future iterations of these models. At this point, most within the insurance industry have recognized the need to go beyond the underwriting fundamentals and investment management. Insurers must take a broader view of risk management and the volatility of earnings in competing with other industries for capital as they seek to provide risk-management solutions to customers and offer shareholders and policyholders the best returns on, and security of, their money.

Going forward, A.M. Best will recognize external output from capital models used by companies to assess the risk in their operations within A.M. Best's rating process. The amount of consideration given to these mod-

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els will vary depending on A.M. Best's view of the company's overall risk-management program, the assumptions underlying the model and the quality of the model itself. An important component to any model is the balance between analytical sophistication and the ability to explain the model to a third party. There is no one formula in determining the amount of credibility afforded a company's capital model. A.M. Best will be meeting with individual companies and model providers to refine A.M. Best's use of external capital models and the level of consideration given to them within the overall rating process.

A.M. Best's Approach

A.M. Best will continue to utilize its internal capital model, Best's Capital Adequacy Ratio (BCAR), as the standard for the evaluation of all rated companies' capitalization. In terms of A.M. Best's rating process, there is no requirement for a company to utilize an internal or third-party model, as every company's capital model needs will differ. However, the ability of a company to monitor and manage its capitalization is an important rating consideration.

Those companies that utilize alternative models to manage their capitalization and assess risk are encouraged to share the output with A.M. Best to enhance the discussion of risk management and capital needs of the company. In considering the value of company capital models, A.M. Best is aware of the potential for "model shopping" and the potential to see only favorable company models. To the extent that a credible alternative perspective of a company's capitalization is provided, consideration will be given to the output from the alternative model. Consideration of other capital models along with BCAR, and other issues such as the financial leverage, operating leverage, liquidity, financial flexibility and earnings volatility, play an important role in A.M. Best's overall assessment of a company's capital strength.

While BCAR provides A.M. Best with an adequate and consistent measure of a company's capitalization in most instances, A.M. Best recognizes that there may be better tools to assess certain risks. Company models may provide a more precise assessment of risk-management tools such as hedging, sophisticated catastrophe management and detailed risk segmentation. Additionally, a more detailed dis-

ussion of a company's capital management tools will provide a better perspective of a company's risk tolerance and approach to managing capital.

The events over the past few years, coupled with the evolution of the industry's focus on enterprise risk management from quantitative model output to an overall process to understand the risk of a company's operation, has helped to build interest in enterprise risk management and the related models. While A.M. Best will not be identifying enterprise risk management as a separate rating consideration, it will be included as an integral part of the rating analysis and discussions with all Secure-rated companies.

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A strong risk-management program will be considered in the qualitative assessment of all three rating areas, Capital Strength, Operating Performance and Business Profile. It also likely will explicitly impact the quantitative view of operating performance through more stable historical earnings. Finally, through the use of a company's own capital model, strong risk management can have a direct impact on the quantitative assessment of capital strength.

A.M. Best will be providing further guidance on the risk management expectations for companies at various rating levels. Through a better understanding of a company's overall risk tolerance and management and the level of detail with which risk is managed within the organization, A.M. Best will be better positioned to assess the credibility of individual company models. A strong risk management program is necessary to support higher ratings, but risk management alone will not support a higher rating. Adequate capitalization to support the rating level given the company's current operations, along with favorable operating performance and a solid business profile commensurate with the rating level, also must support any rating.

Best's Capital Adequacy Ratio (BCAR)

A.M. Best's capital models long have been the most dynamic of those models utilized by the rating agencies, with adjustments related to specific company issues, as well as current industry trends. A.M. Best's large insurance database is a critical starting point, but information derived from the Supplemental Rating Questionnaire provides more refined company data through which every company's BCAR is adjusted to relate to its specific risk characteristics. Industry surveillance also allows A.M. Best to adjust the overall model parameters to reflect the most recent industry information with the risk factors.

In the effort to continue to maintain high-quality capital models, A.M. Best has taken on several initiatives over the years. These changes include the consideration of the

assessment of exposure growth; consideration of the property/casualty underwriting cycle in risk charges; and the catastrophe/terrorism stress test. A.M. Best also expects to update the property/casualty underwriting risk factors to better reflect the current environment.

Similarly, various elements of the life/health model have been revised and updated. In recent years, A.M. Best completed a comprehensive review of default risk factors by asset class; revised the approach to assessing morbidity risk by product to reflect the benefits of scale and diversification in terms mitigating risk; modified the risk charges for separate accounts and revised the spread-of-risk calculation in consideration of the industry's rapid asset growth; and formalized the calculation of equity credit for surplus notes. Currently, A.M. Best is in the process of reviewing the risk metrics related to variable annuity contracts with secondary guarantees, as well as developing a more comprehensive approach to assessing spread of risk on invested asset portfolios.

Finally, over the past two years, A.M. Best has moved away from generic minimum capital levels within its rating analysis. In establishing the level of capital a company must hold to support a given rating level, explicit consideration is given to the actual and potential volatility demonstrated in the company's operation. The minimum capital levels published for given rating levels should be viewed as the levels required of those companies that have demonstrated stable and strong operating results over the long term.

Summary

A.M. Best recognizes that the risk environment and the tools used to monitor that risk are continuing to evolve. Through these changes, A.M. Best continues to address the challenge of utilizing the appropriate level of sophisticated model for each company. A.M. Best rates to appropriately assess its risk, while at the same time ensuring consistency in the overall assessment of each company's financial strength.



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