Rating Agencies Are Positive on ERM

Why Insurers Need to Pay Attention

By Mark Murray

Rating agencies are placing more value on enterprise risk management (ERM), so it is critical for insurers to recognize the benefits of targeted investments in enhancing their organization's ERM capabilities.

The financial crisis demonstrated the resilience of the insurance industry in the face of certain types of systemic risk. Even so, the severe economic downturn hurt insurers' execution of business planning. One ripple effect of the financial crisis is the heightened focus of rating agencies and regulators on ERM and its role within the rating/regulatory process.

While ERM is not a new concept, its increasing influence on ratings and regulations cannot be ignored. As the methodologies employed by rating agencies and the reporting requirements set by regulators become more prospective in nature, ERM analysis as a leading indicator of a firm's ability to operate within a controlled risk/reward framework becomes that much more influential on how a company is rated or regulated.

What is now universally acknowledged is the value and benefit of a strong analytical framework that properly uses technology and modeling tools to assist in an organization's daily business decisions, aligning risk decisions with acceptable corporate-wide tolerance levels. The presence of these tools has yet to outwardly influence explicit rating agency or regulatory capital requirements, but the absence of these tools will increasingly make it more difficult for an organization to respond to regulatory and rating agency inquiries into management's view of its capital needs and the linkages to defined risk tolerance levels or risk appetite statements.

Rating agencies are increasingly recognizing correlations between ERM strength and company performance as risk management evaluations and the definition of strong ERM evolve, so that sophisticated tools are not just a luxury for only the largest, most complex organizations, but a necessity for all.

ERM Is Evolving

The role of ERM within the rating process continues to develop as methodologies evolve and experience in evaluating ERM in greater detail contributes to a more transparent communication of its influence on ratings. Also, the practical applications of an insurer's ERM framework have become more prominent in rating agency communication, as well as a differentiator to achieve higher ratings and possibly relaxed capital requirements.

As rating agencies become more focused on prospective credit assessments, the analysis of ERM as a leading indicator of a firm's ability to operate within a controlled risk/reward framework becomes that much more influential on the final rating outcome and related capital requirements. Nevertheless, rating agencies acknowledge there is still much work to be done before they outwardly recognize the value of ERM in rating and ultimately loosen capital requirements.

Rating agencies indicated they believe the benefits from heightened regulation will continue to contribute to the prioritization of risk management improvements. However, rating agencies will likely still represent the most challenging ERM evaluation for many insurers for the foreseeable future, since they have taken a lead role in emphasizing its importance, and the regulatory evaluation process is

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still in its early developmental stage. Furthermore, the rating agency evaluation of ERM is tied to a rating level and not simply focused on meeting minimum objectives for compliance purposes.

Therefore, it is extremely important for insurers to continue making improvements toward the strategic utilization of ERM in their businesses, which is a critical component in the rating agencies' recognition of the value of an insurer's ERM framework within the rating process.

Same Focus, Different Approaches

This article compares the ERM methodologies and criteria of Standard & Poor's (S&P) and A.M. Best (Best), two of the rating agencies identified in Towers Watson's 2012 Global ERM Survey. S&P and Best have taken slightly different approaches to incorporating the evaluation of ERM into their rating procedures. For example, S&P views ERM as a separate rating component, while Best views ERM as the common thread in its evaluation of balance sheet strength, operating performance and business profile.

Figure 1. The evolution of the S&P ERM framework

Main areas of S&P's ERM analysis

2005	2013
Risk management culture	Risk management culture
Risk controls	Risk controls
Extreme event management	Emerging risk management
Risk and capital models	Risk models
Strategic risk management	Strategic risk management

Despite these modest differences, the objectives of evaluating ERM and the impact on ratings, as well as the evolution of the ERM evaluations, are very similar. Both organizations have introduced several iterations of risk management rating criteria that will continue to evolve, adding more transparency and clarity to how specific aspects of ERM evaluation work and the characteristics of both strong and weak ERM.

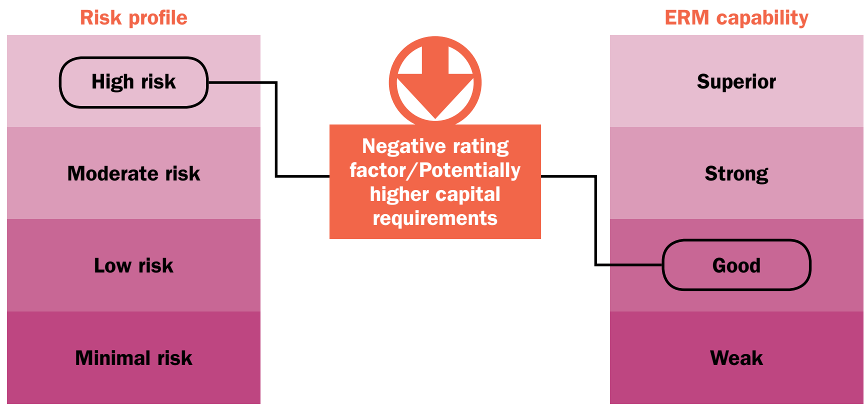
Similarly, the ERM methodologies of both S&P and Best have evolved to include a willingness to relax capital requirements when a company demonstrates strong ERM and capital modeling capabilities. While there is no evidence to suggest the rating agencies are relaxing capital requirements based on a company's own internal model, stochastic modeling capabilities are absolutely necessary for management to feel confident in its own view of capital, a critical component of the ERM evaluation.

S&P's Criteria Become More Granular

In 2005, S&P was the first rating agency to issue a criteria paper that specifically outlined ERM's impact within the rating process. Since then, S&P has issued many ERM criteria updates, the latest of which is the most detailed explanation of what determines the overall ERM score and the score's contribution to the overall rating. While these iterations of ERM criteria have generally been consistent, they have continued to raise the bar on insurers. As outlined in *Figure 1,* it appears as if little is different in the current version from its first iteration in 2005.

Still, the ERM evaluation has evolved, and the methodology has transformed into a more granular and transparent description of the factors and views contributing to the overall ERM score. The most current version of the ERM scoring system uses scores of excellent, strong, adequate and weak. Additionally, S&P has broken down the adequate score into three distinct levels, in order of lowest to highest: adequate, adequate with strong controls and adequate with positive trend. (Adequate with positive trend indicates a score that may improve within the next 24 months.)

Figure 2. Risk profile is a pivotal part of a Best rating assignment



Source: A.M. Best

While the scoring system has become more transparent and the definitions of the scores have been clarified, the most salient change has been the view toward the role of risk models within the ERM criteria. In the past, risk models were viewed as a luxury and were not explicitly identified as a requirement for the highest ERM scores. Currently, S&P has mandated that to achieve a score of adequate with strong risk controls or better, the evaluation of risk models must at least be neutral, meaning an insurer must demonstrate model results are used to support decision making even if it doesn't use risk models extensively for all risks. These changes, while incremental for the latest iteration, reflect the continuous evolution of ERM within the S&P rating process.

Also not evident from the comparison of S&P's ERM analyses is an evaluation of an insurer's economic capital (EC) model through what is called an ERM Level III review. This was not explicitly part of the 2005 methodology and was formally introduced in 2011. One of the more profound implications is the potential for insurers to use their own EC models to determine, in part, the level of capital needed to support a particular rating level. It is likely that the evaluation of an insurer's EC model and the contribution to and influence on the ERM score will evolve over time, similar to the evolution of the ERM evaluations.

Best's Focus on Transparency

Similar to S&P, Best issued a criteria paper in 2008 outlining the ERM evaluation approach and updated it in 2013. The latest iteration aims to increase transparency of the ERM evaluation within the rating process by outlining the strong and weak characteristics associated with each ERM evaluation component. The latest version of Best's ERM methodology also included new commentary on Best's willingness to reduce capital requirements for insurers that demonstrate strong ERM and EC modeling capabilities. This illustrates how Best's application of ERM to its ratings has evolved.

Best's approach to and execution of incorporating the ERM evaluation within the rating process differs slightly from S&P's approach, but the overall analysis is generally consistent. Best evaluates three ERM components: culture, identification and management, and measurement. They are evaluated relative to an insurer's risk profile to assess ERM, which in combination with an evaluation of traditional risk management capabilities determines an insurer's overall risk management skills.

As depicted in *Figure 2,* the impact of risk management on the Best rating is contingent on the insurer's risk profile, similar to S&P's approach.

Best's methodology and criteria for evaluating ERM are quite similar to S&P's despite significant variances in size, complexity and ownership structure of insurers in Best's rated universe. Specifically, the effectiveness of risk management capabilities is compared to the insurer's risk profile in determining the impact on the insurer's ratings, creating a comparative analysis of ERM capabilities that reflects an insurer's needs as evidenced by its risk profile rather than an absolute measure that ignores the variability of the insurer's business.

Best differs from S&P in that it has not developed a methodology for evaluating EC models and does not subject companies to detailed EC model reviews. While it's conceivable Best will develop a methodology to evaluate the contribution of an insurer's EC model to the overall ERM scores, the current evaluation is based on the model uses and subsequent impact these have on the insurer's performance and capital levels. Best has identified characteristics of a strong EC model, but it will take time before it is confident enough in the models to relax capital requirements. Management will need to show reliance on the model in making business decisions that have been validated through experience. S&P takes a somewhat different approach, using an explicit methodology outlining the contribution of the sub-score for risk models to the overall ERM score.

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What to Expect in the Future

Both organizations have commented on how insurers' risk management skills have improved, with further improvements expected. They anticipate the regulatory changes aimed at improving solvency oversight are already having a beneficial impact on their ERM evaluations, although they are reserving judgment on how much they will be impacted. Certainly, they expect a significant overlap in the information flow that will be required for regulatory compliance but will also serve the rating agencies. Even so, the approach and execution of regulatory oversight and rating agency opinions will always have some nuances that make them unique because the objectives for each constituent are quite different.

Prospectively, what risk management evaluations can we expect from the rating agencies, and how will they directly affect insurer ratings? The one certainty is change. As insurers improve their ERM framework and the relative comparisons made within the rating process are felt, rating agencies' evaluation of ERM on overall ratings will continue to evolve.

For example, it is conceivable that at some point in the near future, rating agencies may determine that EC modeling capabilities are not only beneficial, but are, in fact, an absolute necessity to compete effectively. This is analogous to the difference between the use and prominence of catastrophe models in the 1990s and their impact on the industry and ratings today. Similarly, EC modeling best practices will likely emerge, and convergence to accepted practices will likely transform the approach and impact ERM evaluations have on ratings.

As we have seen since the introduction of ERM evaluations, the process and impact on ratings is continuously developing, with a greater focus on risk management tools and practices as differentiators within the evaluation of ERM. However, these tools need to be effectively used in risk-based decision making across the organization to warrant favorable treatment by the rating agencies.

Who Will Benefit From ERM?

Insurers that benefit from ERM evaluations on ratings will be those companies that use ERM strategically to inform risk-based decisions and are rewarded through rating upgrades and lower capital requirements. Those companies that view ERM as a compliance and documentation exercise will not reap the rewards of targeted investments to better measure and manage risk accumulations, and will not tap the strategic value of ERM as an offensive tool in planning and executing business plans.

Longer term, insurers that do not embrace enterprise-wide risk management expose themselves to potentially greater volatility in their business performance relative to expectations set with the rating agencies as well as relative to peers and competitors. This will place pressure on ratings and increase capital requirements, potentially creating a competitive disadvantage by increasing the cost of assuming risk relative to peers. And as many in the industry are already discovering, the investment in risk management is not cheap and does not provide meaningful returns on that investment overnight.

However, rating agencies increasingly recognize the value of a strong risk management framework, and it is critical that management recognize the benefits to the rating agency relationship when considering the prioritization of targeted investments in enhancing their organization's ERM capabilities.

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