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Study of Insurance Economics

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**The Insurance Industry and Enterprise
Risk Management: From Compliance to
Value Creation**

21 November 2007

Milan

&

Uninsured Industrial Risks

Ongoing Research Project
by Tileman Fischer

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Layout & Distribution: Valéria Kozakova

Enterprise Risk Management as a Competitive Advantage

Laura Santori

Agenda

- **Standard & Poor's view of ERM**
- **The Controlled Risk Taking Environment**
- **The Upside of ERM**

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Standard & Poor's view of ERM

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The Value of Good Risk Management

The purpose of Risk Management is to...

- 1) Identify and monitor significant risks
- 2) Set risk limits for each risk to reflect the company's risk tolerances, competencies and resources
- 3) Design program to measure all risks consistently with fundamental objectives of the enterprise.
- 4) Execute the risk management programs to limit losses to within the company's risk tolerances

The product of Good Risk Management is a controlled risk taking environment

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What Is the Difference Between Risk Management and ERM?

An ERM Program comprehensively applies Risk Management:

- Across ALL of the significant risks of the Enterprise
- Consistently across the risks
- Consistently with the fundamental objectives of the enterprise

An ERM Program reflects risk capital in:

- Strategic decision making
- Product design and pricing
- Strategic and tactical investment selection
- Financial performance evaluation

The product of a fully-realized ERM Program is the optimization of enterprise risk adjusted return

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ERM Evaluation Components



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The Controlled Risk Taking Environment

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The Controlled Risk Taking Environment

Strategic Risk Management

Risk Control Processes Emerging Risks Mgmt Risk & Economic Capital Models

Risk Management Culture

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The definition of Risk Tolerance

Risk Management Culture:

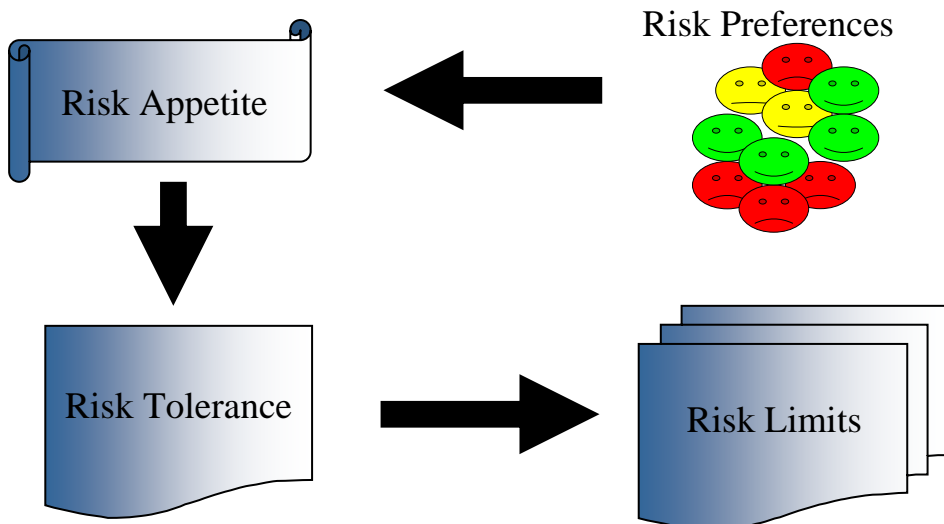
- Highly qualified risk management staff
- Regular communication with board on risks positions and risk management programs
- Clear and wide known risk management policies and procedures
- Manager's compensation is linked to the achievement of risk management objectives (RoEC, RoEV)
- Company's governance structure supports effective risk management
- Risk measurement and monitoring is independent from risk taking and management
- **Clearly articulated risk preference, appetite and tolerance, translated into risk limits**

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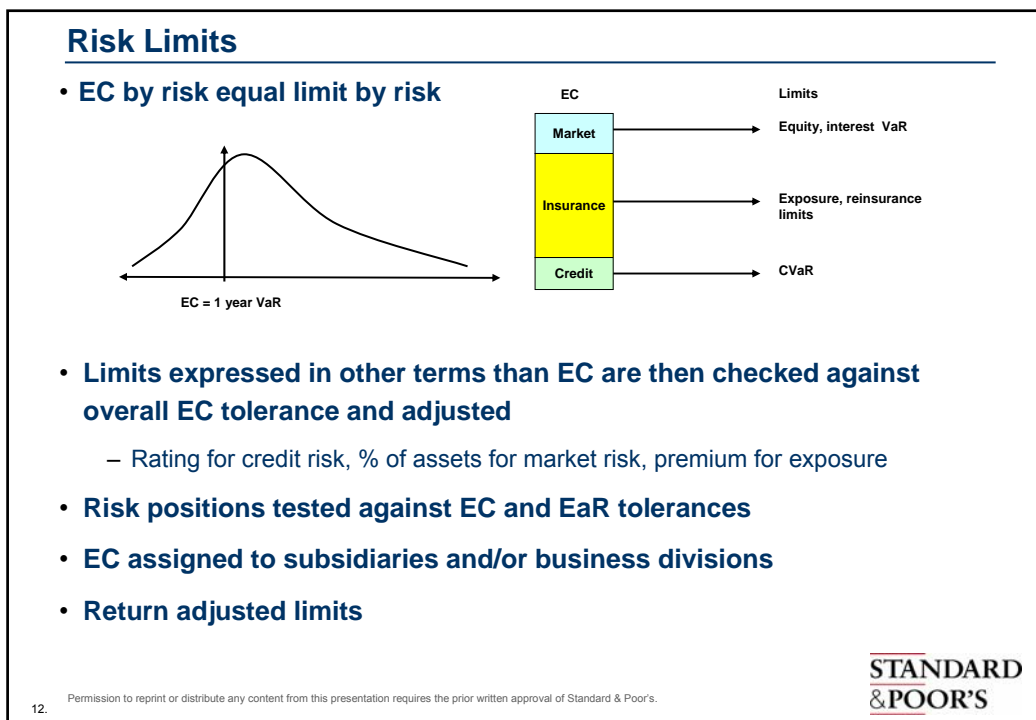
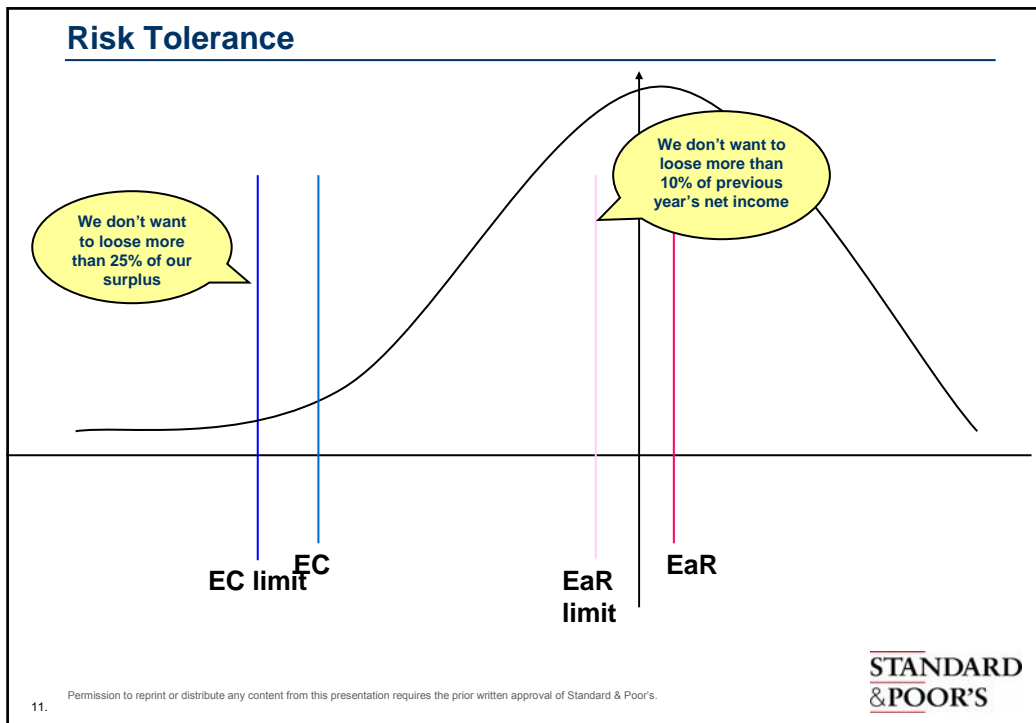
Process to set Risk Tolerance & Limits



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The importance of a Risk Profile

- **A strong risk culture will enable the company to demonstrate their risk profile and discuss it clearly:**
 - The risk profile should be simple and explainable
 - Ensures that senior management understand it and it can be used, i.e. it is not just an intellectual exercise
 - The metrics used should be linked to the Risk Tolerance
 - Do they measure earnings at risk measures?
 - Do they use Capital at Risk measures?
 - The profile should be compared to the tolerance limits
 - If the overall limit is 10 what is the current position
 - Traffic lights can be used to indicate proximity to limits
 - Actions should be clearly identified where exposure is different to limits
 - Where exposure is close to, exceeds or well below limits then what action is management taking to address gaps.
- **The discussion of the profile should be a key part of the ERM analysis and will define the key risks for the ERM summary report.**

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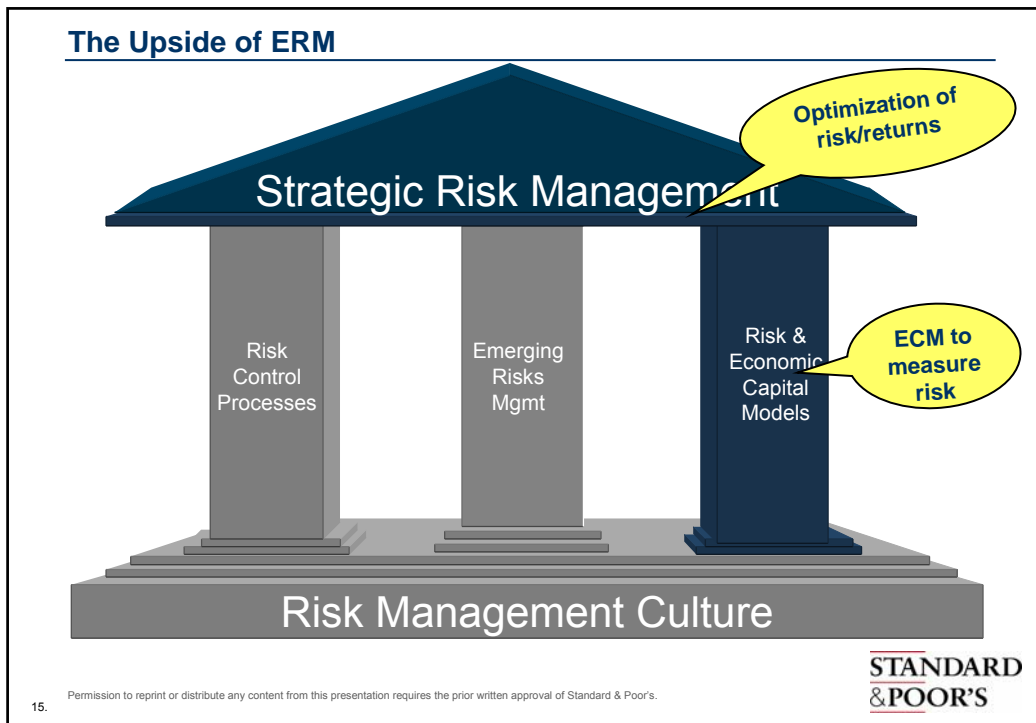
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The Upside of ERM

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Strategic Risk Management

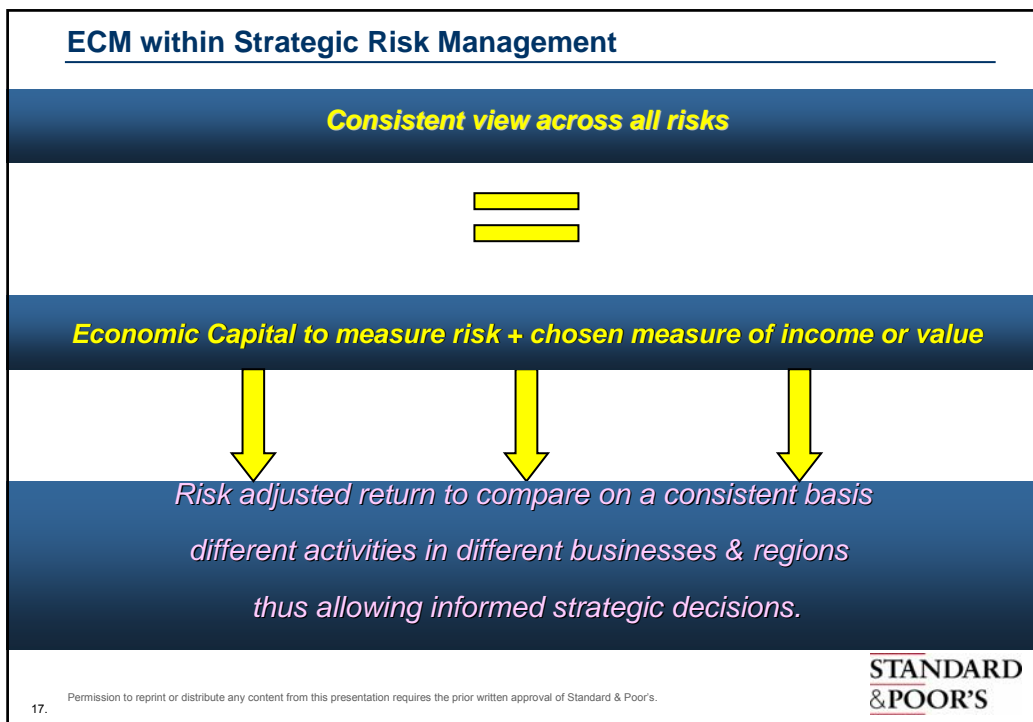
What do we look for:

- **Consistent view across all risks**
- Capability to assess trade-offs between different risk types
- Assessment of risk adjusted returns
- Capital budgeting
- Strategic investment allocation

Objective: To Optimize Risk-adjusted Returns

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Strategic Risk Management

Why are we making SRM so important?

- **There are some companies with Superior Risk Management that we don't consider having Strong ERM:**
 - Companies with Superior Risk Management (Controls) will have volatility of earnings and incidence of losses within their tolerances
 - Companies with Strong/Excellent ERM will have low volatility of earnings, low incidence of losses **AND will maximize their risk/return relationship!**
- **Strategic Risk Management is the UPSIDE of Risk Management**

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Strategic Risk Management Practices

- **Impact of Strategic Decisions on risk profile and risk appetite is key part of the strategic decision making process.**
 - Risk Limits that are tied back to risk appetite & risk tolerance
- **Optimize the risk-reward result from a very quantitative approach.**
 - Activities with lower risk adjusted returns are regularly reviewed to either increase returns (or reduce risk)
- **Strategic Asset Allocation** – performed not just with regard to risk reward choices among investments but also reflecting the entire risk profile of the insurer, especially the aspects of the insurance liabilities that have a high correlation to capital
- **Risk-adjusted product pricing** including market consistent pricing of features that can be replicated by market traded instruments.
- **Capital budgeting** that is incorporates information about risk reward choices
 - Also includes decisions on dividends/stock buy-backs and other capital raising and distributing activities
- **Performance recognition and incentive compensation** linked to risk-adjusted financial results

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Strategic Risk Management - Examples

For Life Insurers:

- **Strategic trade-offs between products with:**
 - Credit Risk
 - Interest Rate Risk
 - Equity Risk
 - Insurance Risks
 - Based on long term view of risk adjusted returns of products
 - Choosing which to write, how much to retain and which to offset
- **Strategic trade-offs in Investment Selection**
 - based on risks embedded in products
 - plus long term view of risk adjusted returns of investment choices

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Strategic Risk Management - Examples

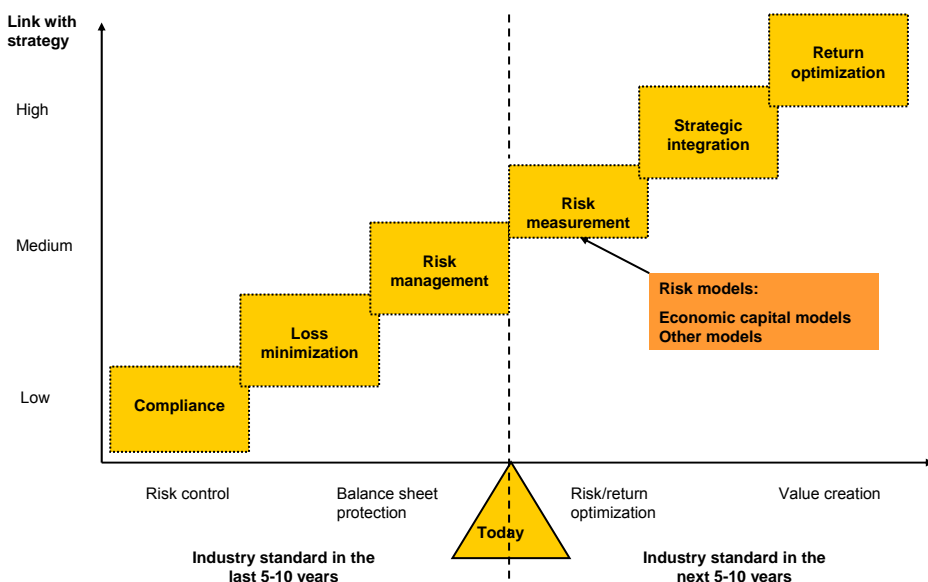
For Non-Life (P&C) Insurers:

- **Strategic Trade-offs among insurance coverages AND investments**
 - based on long term view of risk adjusted return
 - Recognizing significance of investment risk to total risk profile
 - Recognizing ceded reinsurance credit risk
 - Selecting which risks to write and which to retain over the long term
- **Some Insurers have 40% or more of their total capital tied to Investment risks**
 - An Insurer with Strategic Risk Management will be able to say why they chose to take that much Investment risk
 - Including discussing relative risk reward of Insurance choices and Investments
 - With consideration of diversification impact of Insurance vs. Investments
- **For Multi-line insurers/reinsurers**
 - Trade-offs between all investment & Insurance risks
 - Trade-offs between Life & non-life



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Conclusion: the Evolution of ERM and the Role of ECM



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