2009 Insurance Economic Summit:
Navigating the New Business Landscape

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2009 Insurance Economic Summit:
Navigating the New Business Landscape

Enterprise Risk Management
An Escalated Focus

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Enterprise Risk Management: Think Big, Start Small

Agenda

- What is ERM? What is it not?
- ERM – Events Contributing to its Escalated Focus
- The COSO ERM Framework
- Why is it important?
- Who is talking ERM?
- ERM survey results
- ERM structure examples
- Case study
- Practical tips to start

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ERM - Definition

*"… a **process**,*
*effected by an entity's **board of directors**, management and other personnel,*
*applied in **strategy setting and across the enterprise**,*
*designed to **identify potential events** that may affect the entity, and **manage risks** to be within its **risk appetite**,*
*to provide **reasonable assurance** regarding the **achievement** of **entity objectives**."*

Source: COSO Enterprise Risk Management – Integrated Framework. 2004. COSO.

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ERM is not…

- a Strategic Planning process
- an Internal Audit process
- a process that does not exist at all in companies today
- a SOX driven initiative
- a process that will prevent all control failures
- a process used by the company's insurance policy buyers
- a process focused just on cash loss
- a project…*it is a process*
- a business risk assessment

ERM is about managing the risks, supportive of the organization's strategic activities.

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ERM – Significant Events

- S&L Crisis of late '80's
- Integrated Framework of Internal Control, released by Committee of Sponsoring Organizations (COSO), 1992
- Blue Ribbon Committee release directed at Audit Committee performance
- Enron, WorldCom, etc.
- Sarbanes-Oxley enacted and Integrated Framework of Internal Control anointed as "the standard"
- Significant financial statement restatements follow and continue
- COSO releases its ERM integrated framework, 2004
- The current "Financial Meltdown"
- Everybody is talking ERM
  - Many companies have begun, few are finished
  - Those that have, are reevaluating
  - Those that have not started, are thinking more seriously about beginning
- No "Standard", yet………

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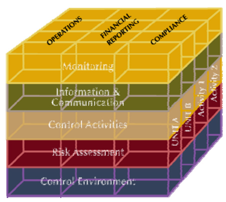
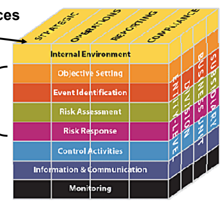
Internal Controls Framework vs. ERM Integrated Framework



Internal Controls:
Integrated Framework –
utilized for SOX 404
(a.k.a., "COSO")

Differences



ERM significantly expands the framework for Risk Assessment

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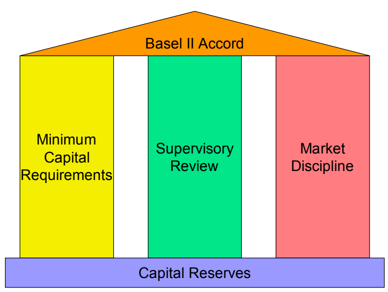
ERM - Basel II Accord
Three Pillars



The goal is for banks and other financial institutions to set aside capital in the event of a market collapse.

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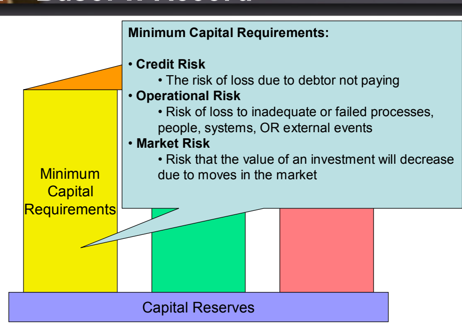
ERM - Basel II Accord



The goal is for banks and other financial institutions to set aside capital in the event of a market collapse.

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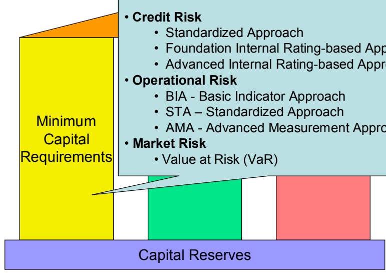
ERM - Basel II Accord

Minimum Capital Requirements:

- **Credit Risk**
  - Standardized Approach
  - Foundation Internal Rating-based Approach (IRB)
  - Advanced Internal Rating-based Approach (IRB)
- **Operational Risk**
  - BIA - Basic Indicator Approach
  - STA – Standardized Approach
  - AMA - Advanced Measurement Approach
- **Market Risk**
  - Value at Risk (VaR)



The goal is for banks and other financial institutions to set aside capital in the event of a market collapse.

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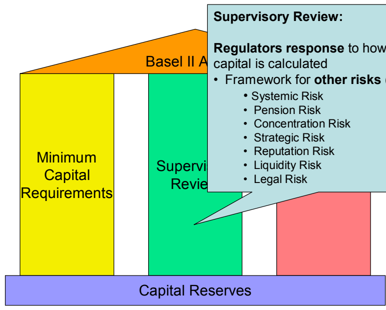
ERM - Basel II Accord

Supervisory Review:

Regulators response to how regulatory capital is calculated

- Framework for **other risks** (e.g., banks):
  - Systemic Risk
  - Pension Risk
  - Concentration Risk
  - Strategic Risk
  - Reputation Risk
  - Liquidity Risk
  - Legal Risk



The goal is for banks and other financial institutions to set aside capital in the event of a market collapse.

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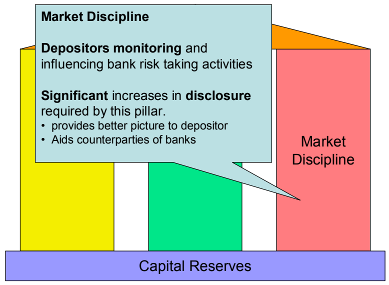
ERM - Basel II Accord

Market Discipline

Depositors monitoring and influencing bank risk taking activities

Significant increases in **disclosure** required by this pillar.

- provides better picture to depositor
- Aids counterparties of banks



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ERM - Why is it important?

Recent study of Audit Committee Members:

- Top 3 concerns
  1. Accounting judgments and estimates
  2. Risk management
  3. Internal Controls
- Audit Committee's not satisfied with oversight of risk management, nor management's process
  - Fraud, taxes and IT Security
- Audit Committee's do not believe they should have primary responsibility for ERM
- ERM not clearly defined at the Board level

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ERM - Why is it important?

- Reasonable assurance – significant risk identified, understood, measured, mitigated
- Enhances interaction with regulators, rating agencies, auditors, shareholders
- Improves efficiency of capital deployment and allocation
- Reduces risk of "surprises" and potential catastrophic impact on capital
- Mitigates organizational threats and can promote business opportunities
- Supports an organizations' ability to achieve critical success factors
- Potential for process improvements and enhancements

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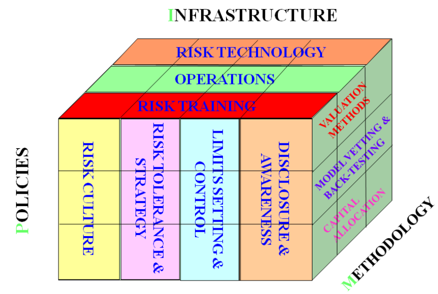
ERM – Who is talking ERM?

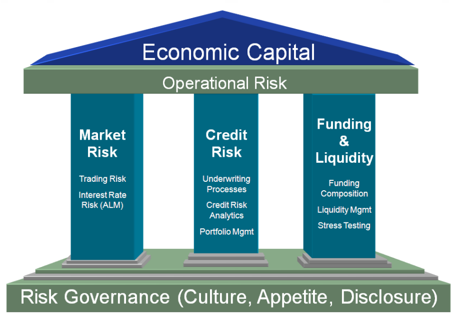
- Regulators – ERM blended into their Risk-based Examination process
- Rating Agencies
  - A.M. Best
  - S&P
  - Moody's
- Shareholders
- Board of Directors
- Management
- Common and Best Business Practice
- Competition
- Stakeholders and Other Drivers

ERM - Standard & Poor's
"PIM" Assessment Components



Provided courtesy of Standard & Poor's

ERM - Standard & Poor's
Evaluation Components for Financial



Provided courtesy of Standard & Poor's

ERM - Standard & Poor's
Quality Classifications

Excellent	• Advanced capabilities to identify, measure, manage all risk exposures within tolerances • Advanced implementation, development and execution of ERM parameters • Consistently optimizes risk adjusted returns throughout the organization
Strong	• Clear vision of risk tolerance and overall risk profile • Risk Control exceeds adequate for most major risks • Has robust processes to identify and prepare for emerging risks • Incorporates risk management and decision making to optimize risk adjusted returns
Adequate	• Has fully functioning control systems in place for all of their major risks • May lack a robust process for identifying and preparing for emerging risks • Performing good classical "silo" based risk management • Not fully developed process to optimize risk adjusted returns
Weak	• Incomplete control process for one or more major risks • Inconsistent or limited capabilities to identify, measure or manage major risk exposures

Provided courtesy of Standard & Poor's

ERM - Standard & Poor's
Evaluation Template

		Assessment & Comments			
	Institution Name	1=Weak	2=Adequate	3=Strong	4=Excellent
	Overall ERM Assessment	○	○	○	○
A.	**Risk Governance**	○	○	○	○
	Risk Culture *Risk Appetite* *Risk Quantification/aggregation* *Risk Reporting and Disclosure*				
B.	**Market Risk**	○	○	○	○
	Trading *ALM*				
C.	**Credit Risk**	○	○	○	○
	Underwriting Processes *Portfolio Management* *Credit Risk Analytics/Modeling* *Reserving & Risk Mitigation Policies*				
D.	**Operational Risk**	○	○	○	○
	Definition *Measurement* *Managing & Reporting* *B/O Infrastructure & Operations*				
E.	**Funding & Liquidity Risk**	○	○	○	○
	Funding Composition *Day-to-day Liquidity Management* *Liquidity Stress Testing*				

Provided courtesy of Standard & Poor's

ERM - Standard & Poor's
Ratings Impact

Ok, How Does This Impact Ratings?

"If an institution falls short of, or exceeds, expectations, would it warrant a downgrade or an upgrade?"

"If there are material weaknesses or significant strengths sure, it could impact rating! If ERM is stellar, it may change our view of management in general and push us towards an upgrade."

- **Prodyot Samanta**
Director, Enterprise Risk Management
Standard & Poor's

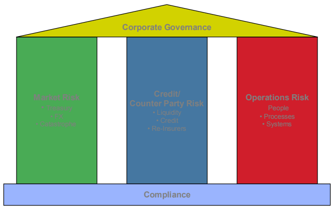
Provided courtesy of Standard & Poor's

2009 Growth Solution Offerings
What will ERM look like?

Basel II Accord 2004 | Standard & Poor's 2007 | Solvency II 2006

ERM 2009 will draw from Basel II and incorporate more recent developments including Operations Risk

2009 Growth Solution Offerings
A View of SMART ERM



ERM 2009 will draw from Basel II and other recognized frameworks, incorporating the integrated skills and knowledge of our professionals

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ERM Survey Results

- GovernanceMetrics International (GMI) and Marsh, Inc.(Feb, 2009)
  - About 200 major companies worldwide
  - 79% employ a formal ERM program
    - 28% in infancy stage
    - 48% mature, with opportunities for improvement
  - 21% do not have a formal ERM program
    - 40% will in next 12 months
  - Startups of ERM programs gained significant traction in the 2004-2007 period, after COSO ERM framework was released, peaking in 2006

(continued)

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ERM Survey Results, continued

- GovernanceMetrics International (GMI) and Marsh, Inc.(Feb, 2009), continued
  - No single ERM standard prevails
    - 54 % - ERM program does not adhere to any particular ERM standard
    - 46% - 67% COSO, 16% AS/NZS 4360, both “best practice” frameworks, neither is mandatory
  - ERM Program emphasis
    - Internal Control, Financial Reporting
    - Strategic Planning/Competitive Risks
    - Legal/Compliance Risks
    - Credit/Liquidity Risks
    - IT Systems/Security

(Continued)

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ERM Survey Results, continued

- GovernanceMetrics International (GMI) and Marsh, Inc.(Feb, 2009), continued
  - Lack of integration/siloed approaches biggest challenge
    - 46% ERM program only partially integrated in the company's routine business processes
    - Other key challenges
      - Lack of metrics (27%)
      - Program informality (23%)
      - Lack of tools (21%)
  - 50% - Audit Committee has primary oversight

(continued)

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ERM Survey, continued

- GovernanceMetrics International (GMI) and Marsh, Inc.(Feb, 2009), continued
  - Although ERM continues to gain important, it is not regularly communicated to investors
    - 75% do not communicate and 73% do not plan to in next 12 months
    - 25% use Annual Report to disclose their approach to ERM
    - View is that investors and independent analysts will demand this communication in the near future

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ERM – Lessons from the Financial Meltdown

- Risk and Insurance Management Society (RIMS) study "The 2008 Financial Crisis: A Wake-up Call for Enterprise Risk Management". Several key failures:
  - Over-reliance on financial models
    - Risk quantification based upon historically-based predictive tools, do not contemplate low probability, worst-case scenarios
    - Affected others as well (i.e.-rating agencies)
  - Too much reliance on compliance and controls
    - Controls can't change human behavior
    - Controls did not evolve in scope or speed sufficiently to keep up with new risks
    - Controls frequently ignored emerging risks

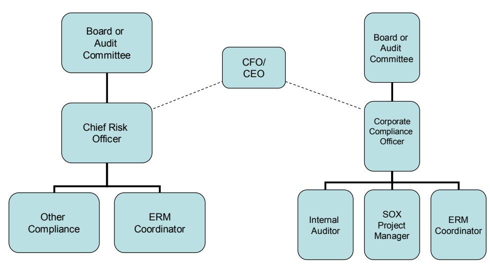
(continued)

ERM – Lessons Learned from the Financial Meltdown, continued

- RIMS study, continued
  - ERM was not embedded throughout the organizations
    - Usually “stuck” at the top
    - Needs front-line ownership and governance as well
  - Organization failure to communicate the risk appetite and monitor to that tolerance
    - Need “brakes” and limits
  - Positive note – The Goldman story
    - Adjusted it position in mortgage-backed securities beginning in 2006, when many competitors thought they were just being overcautious
  - Story at Fannie Mae and Freddie Mac not as pretty

ERM: How is it being structured?

Two Examples



ERM - Getting Started

Case Study

US Based Insurance Company

- Multi-country
- Well capitalized
- Two day retreat, NYC
- Top 20 officers

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Case Study
Phase I – Internal Environment

A. ERM driven by CEO
B. Architect retreat – two months prior
 - Identify participants
 - Benchmark ERM at the start – three weeks prior
   - Share results at start of retreat
   - Compare months later
C. Evaluate mistakes / lessons learned from others
D. Define “risk appetite” and “risk tolerance”
 - Be as specific as possible
E. Articulate Objectives

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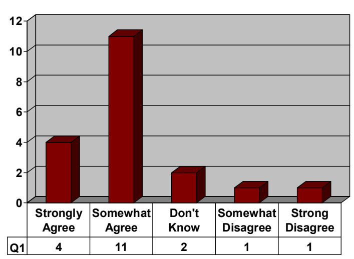
Case Study
Phase I – Benchmarking

Question 1. I understand the basic concepts of Enterprise Risk Management.



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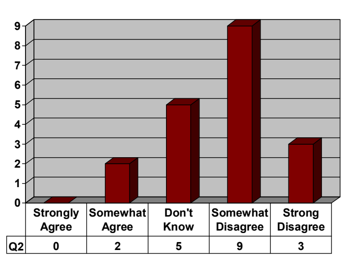
Case Study
Phase I – Benchmarking

Question 2. Our risk management philosophy is well developed, understood and embraced by company personnel.



Case Study
Phase II – Identify Events

A. Events vs. Risks

B. Ensure completeness of risks

Case Study
Phase II – Event Identification – Added Thoughts

Economic
- Capital availability
- Credit issuance, default
- Concentration
- Liquidity
- Financial Markets
- Unemployment
- Competition
- Merger/Acquisition

Natural Environment
- Natural disaster
- Emissions, waste
- Energy
- Sustainable development

Political
- Governmental change
- Legislation
- Public policy
- Regulatory

Social
- Privacy
- Terrorism
- Demographics, consumer behavior

Technological
- Interruption
- Emerging technology
- Data collection and reporting

Case Study
Phase II – Event Identification – Added Thoughts (cont.)

People
- Skills, capability
- Integrity
- Ethics
- Succession
- Fraud
- Environment and safety

Process
- Capacity
- Design
- Execution
- Integrity
- Three party dependency

Technology
- Data integrity
- System availability
- System selection
- Development
- Deployment
- Maintenance

Infrastructure
- Availability of assets
- Reliability of assets
- Access to capital
- Complexity

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Case Study
Phase III – Risk Assessment

A. Robust debate within smaller groups

B. Identify "Top 10" – settle for "5 best (or worst)"

C. Impact and probability of each risk

D. Most complex business problems rose to the top

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Case Study
Phase IV – Risk Response

A. Robust debate within smaller groups

B. Reconfigure groups for balanced perspective

C. Existing strategy and controls

D. Additional or modified strategies

E. Responsible Officer / Accountability

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Case Study
Phase III – Risk and Response (example)

Risk 10: Collection of re-insurance /failure of re-insurer

Risk Category: Medium

Risk Assessment Consideration: ABC is largest receivable
If ABC deal goes bad, could lead to litigation, affect re-insurer's ability
to pay. Re-insurer suffers a catastrophe.

Impact: Medium **Likelihood:** Medium **Time Horizon:** Immediate / Ongoing

Risk Response/Management:
Existing Strategy and Controls – existing controls to monitor losses ...

Additional Identified Strategy/Control Issues Regarding Action in 2007 – increase frequency to review re-insurer...

Responsible Parties: David Smith (losses recoverable), Janet Stewart (contingent commission) and Tina Brown (premiums recoverable)

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Case Study
Phase V – Control Activities and Information & Communication

A. Data is one critical factor in moving forward

B. Quantification and modeling

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Case Study
Phase VI – Monitoring

A. Charter

B. Team composition

C. Meetings, frequency

D. Internal Audit role

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ERM - Lessons Learned

- Cookbook approach is not feasible – too much depends upon organization culture
- Create a formal, dedicated effort to identify all significant risks
- Risks must be ranked on a scale of importance, severity, dollar amount
  - Frequency or probability
- Measure financial risk with most sophisticated, relevant tools available
  - VAR, Stress testing or another understandable method (e.g., earnings at risk)

(continued)

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ERM - Lessons Learned (cont'd)

- Define the organization's risk appetite
- Apply more rigor to non-financial risks whenever possible
  - Modeling is not often possible
  - Random nature of operating risks
- Recognize various combinations of acceptance, transfer and mitigation to manage risk
  - Continuously re-evaluate
  - Transfer when opportunity arises
- Consider risk as part of management's decision-making process

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ERM – Practical Tips to Start

- **Start Small** – avoid going deep and long for now
- **Keep to the Top 10 Risks** – contain discussion to the top officers of the organization
- **Keep your own score sheet** – do not overemphasize quantification of risk, start with qualification
- **Create the expectation that ERM is not your baby** – serve as a process facilitator
- **Focus on Operation's controls** - ERM is overly inclined to take a financial path

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Thank you!

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