



# NAVIGATING FINANCIAL STRENGTH RATINGS

Maintaining the Momentum in Shifting Tides

**AON** BENFIELD

Aon Benfield's Rating Agency Advisory group has substantial experience helping clients navigate various criteria changes and ERM developments. The tangible result of our consultative advice is a full understanding of the factors that matter to your rating and achieving the highest appropriate rating for your risk profile.

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# Navigating Financial Strength Ratings

## MAINTAINING THE MOMENTUM IN SHIFTING TIDES

Given the downward trend in rates, coupled with weakened investment markets and the current credit crisis, pressure on financial strength ratings remains a critical concern for many insurers’ senior management teams. Although stable outlooks are formally assigned to most P&C sectors by the major rating agencies, many wonder if the industry can continue to withstand the softening pricing and concurrent investment losses without a significant decline in overall industry capital or confidence. From the industry perspective, many insurance company management teams are understandably frustrated after delivering favorable operating returns and substantially improving capital bases while chasing evolving ratings criteria that frequently lacks clarity in both mechanics and interpretation. Companies are also currently frustrated with the lack of firm guidance on how the rating agencies will treat the mounting investment losses across the industry, and what possible future criteria changes may result from the current financial markets turmoil.

While no single factor will determine the assigned financial strength rating, there are generally three to five critical issues that your company will need to address. Some will be systemic to the industry and/or your sector, while others relate to your individual company dynamics. Recognizing rating agencies’ current concerns regarding the insurance industry, it is important to examine your specific sector and company as the first step in anticipating sources of ratings pressure. The hard market conditions that followed the 1997-2001 underpricing cycle, the terrorism losses suffered on September 11, 2001, and the natural catastrophe losses of 2004 and 2005 are generally viewed by the agencies as only being sufficient to achieve adequate returns for the volatility assumed. Therefore, given softening market conditions in 2007 and 2008, rating agencies are concerned that as rates continue to rapidly decline, returns will follow.

In the past year, the Rating Agencies generally have shifted their primary focus from refining their capital models and quantitative criteria to a heightened focus on Enterprise Risk Management (ERM) and more recently Cycle Management. Underwriting cycle management is currently one of the two leading topics in rating agency dialogue, in addition to Investment Strategy and Management. The rating agencies are undertaking a critical review of companies’ investment

portfolios to assess existing and future strategy; the value of both realized and unrealized losses; as well as its liquidity needs and financial flexibility.

After the 1997–2001 underwriting results became clear, rating agencies told companies to restore capital adequacy, strengthen their reserves and stabilize their profits in order to alleviate ratings pressure or achieve ratings upgrades. Companies have made clear, undeniable progress in these goals, and many are frustrated that the agencies are requesting to see how these companies perform in this softer market before positive ratings actions are taken. From the agencies’ point of view, the recent years’ hard cycle provided all companies the opportunity to write business profitably while strengthening their balance sheets.

Now the questions are: How will these companies perform in the current cycle? Is the previous soft cycle any indication of which companies will succeed and which ones will fail? What has been learned from past cycles? In order to achieve positive ratings movement at this time, it is critical to have a differentiating story, supported by tangible evidence of intelligent underwriting decision-making. Given where we are positioned in the cycle, this is an opportunity for companies to present their approach in practice.

SECTOR	OUTLOOK			
	S&P	A.M. BEST	MOODY’S	FITCH
Personal Lines	Stable	Stable	Stable	Negative
Commercial Lines	Negative	Stable	Stable	Negative
Reinsurance	Stable	Stable	Stable	Negative
Health	Stable	Stable	Stable	Negative
Life Insurance	Negative	Negative	Stable	Negative

## NAVIGATING FINANCIAL STRENGTH RATINGS

The following are questions that we have seen analysts asking our clients, showing a comprehensive concern regarding the ability to maintain underwriting discipline through a tough market:

- > What is your target threshold for underwriting a risk (e.g., Combined Ratio, ROE, etc.)?
- > How will the CEO and CFO know when that threshold has been breached? How will the underwriter know?
- > How are you capturing slippage in terms and conditions as well as rates?
- > Is any part of underwriting compensation tied to volume?
- > If you struggled during the last soft part of the cycle, what exactly are you doing different this time?
- > Has your strategy changed or is it changing with respect to the strong reserve adequacy you have been proudly displaying at recent analyst meetings?
- > If you are willing to be disciplined in underwriting, what measures are in place to manage the expense ratio?

A company that is well prepared to tackle the current soft cycle should be able to answer these questions, and again, provide tangible support for its practices.

The rating agencies have said that they believe that the industry currently has sufficient capital to absorb existing investment losses. However, given the widespread declines in investment values, they are increasing their analysis of cycle management as companies need to generate positive underwriting results to help offset the investment losses. Companies who have aggressive investment strategies and weak cycle management will face ratings pressure.

## Insights

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**KEY TO MANAGING YOUR FINANCIAL STRENGTH RATING IS MANAGING THE RELATIONSHIP WITH THE RATINGS ANALYST AND EXPECTATIONS OF THE ANALYST AND THE RATINGS COMMITTEE. CRITICAL SKILLS FOR ALL RATED COMPANIES INCLUDE:**

- > Thorough communications with the rating analysts including all areas of potential concern – too often companies avoid lengthy discussions of uncomfortable topics such as adverse reserve development or exposure to (or actual) earnings volatility. Avoiding such topics will poorly reflect on the rating agencies' views of management and corporate strategy, which is often the most critical rating category. Conversely, some companies focus solely on the problems encountered and neglect to emphasize the differentiating strengths they have.
- > Full understanding of the metrics used by the rating agencies to evaluate the various rating categories in areas such as capitalization, operating returns, leverage ratios, and catastrophe exposure. The ability to communicate management's position on these topics, evaluate the rating analysts' assessments and predict how your prospective business plan will be reflected through these metrics can bridge the gap between your expectation and that of the rating agency.
- > Clear articulation of your Enterprise Risk Management program. Demonstrating an understanding of the practical risks to the organization, how these risks are correlated, and how they can be quantified under a variety of methods can result in greater capital efficiency required to maintain current ratings.
- > Recognition of how your financial strength and results of operations compare to your peers. Ratings are heavily influenced by relative measures and even solid performance can go unrewarded if you under-perform your sector. Clear understanding of the agencies' peer selection is also critical to enable you to properly differentiate your company and explain any anomalies in the comparisons.

## Tools and Solutions

AON BENFIELD HAS SUBSTANTIAL EXPERIENCE WITH THE ANALYSES USED BY THE MAJOR RATING AGENCIES TO ASSIGN INSURER FINANCIAL STRENGTH RATINGS AND PROVIDES COMPREHENSIVE RATING AGENCY SERVICES TO ALL OF OUR CLIENTS. OUR CONSISTENT SUCCESS HELPING OUR CLIENTS OBTAIN INITIAL RATINGS, MAINTAIN CURRENT RATINGS AND MANAGE FUTURE RATINGS ACTIONS, ALL IN ACCORDANCE WITH CORPORATE GOALS, STEMS FROM THE FOLLOWING CAPABILITIES:

- > Experience in providing consultative advice to hundreds of insurers on rating agency issues through years of evolving criteria.
- > Well-established relationships with key analysts and criteria standard-setters at the various rating agencies, which enables us to understand and anticipate sources of ratings pressure.
- > Avenue to ask anonymous questions on behalf of our clients.
- > Fully developed templates to recreate capital adequacy, earnings adequacy and other vital metrics executed in-house and made available to our clients.
- > Proprietary scenario analysis and planning model, whose output includes five-year financial projections, which are fully integrated into our rating agency templates, allowing for a prospective look at financial consequences and rating agency implications of reinsurance and other planned transactions.

## Criteria Updates

### A.M. BEST

In July 2008, A.M. Best released a study on cycle management, and concluded that few companies excel at managing through market cycles. It determined that only 14 percent of the total study population outperformed their industry composite medians over the most recent soft and hard cycles.

A.M. Best noted that companies who focus on underwriting to drive profits perform better through the cycle. Additionally, the top performers managed their loss reserves more conservatively. During the previous soft cycle, the more poorly performing companies were aggressively reducing reserves from prior years to help offset pressures on underwriting performance and maintain their capital adequacy. Needless to say, this same group ultimately increased reserves for prior years' losses by much larger percentages between the years of 2002–2004, while companies who took a more consistent approach to reserving experienced more stable development patterns. Both of these points reflect the need for companies to actively manage the cycle through specific underwriting practices and consistent reserving.

The more poorly performing companies typically relied on higher net investment returns to offset underwriting losses. This led to lower Returns on Revenue and Returns on Equity compared to their top performing peers. Further, these companies saw greater volatility and variability in their overall earnings, and these spreads

widened as the environment became more competitive. With the current turmoil facing the investment markets, companies that succeeded in relying on investment returns to offset underwriting losses will find it more difficult to pursue a similar strategy during this underwriting cycle.

A.M. Best has recently undertaken a detailed review of companies' investment portfolios. They requested that companies provide detailed investment data, including realized and unrealized losses, at both September 30 and again at October 30. A.M. Best has said that they do not expect widespread downgrades resulting from unrealized losses alone. However, companies that had aggressive investment strategies that resulted in unexpected investment losses not in line with a strong Enterprise Risk Management framework will face ratings pressure.

As a part of the investment analysis, A.M. Best will analyze in detail a company's liquidity needs and financial flexibility. To the extent that a company has strong liquidity from operating cash flows or highly liquid assets, and will not need to sell its devalued assets and "realize" the losses, the company will likely not be downgraded in the short-term. A.M. Best is also reviewing financial flexibility to determine what additional sources of capital a company has available should it need it. Again companies who have weak liquidity or do not have access to capital will face ratings pressure.

## NAVIGATING FINANCIAL STRENGTH RATINGS

Over the past year, A.M. Best has also introduced several new changes to its BCAR (A.M. Best's Capital Adequacy Ratio) model and criteria that are generally applicable to all companies globally, the first of which directly responds to the current soft cycle. An excess growth charge has historically been incorporated into BCAR. Excess growth is calculated based upon the increase in one-year and three-year growth in policy counts or gross written premiums. For those companies that grow in excess of the stated thresholds, A.M. Best will apply a growth penalty to both premium risk and reserve risk for the difference (up to a maximum charge of 50 percent). In February 2008, A.M. Best reduced its thresholds for excess growth which in turn increases the capital requirements for those companies that are growing policy counts or premiums at a pace faster than capital (the excess growth penalty will be applied at between 4 percent and 6 percent growth). The intent is to ensure that companies are maintaining underwriting discipline and not simply growing their books of business without obtaining adequate rate for the risks.

At the A.M. Best Review/Preview conference in early March 2008, A.M. Best announced they are planning to incorporate a Terror Probable Maximum Loss (PML) into the BCAR calculation, as opposed to the separate terrorism test currently in place. The proposed Terror PML will be calculated by A.M. Best for U.S. companies based on the on the occurrence losses as reported in the Supplemental Ratings Questionnaire (SRQ). The greater of the Terror PML or Natural Catastrophe PML will be used for the first catastrophe loss. The second event loss will

continue to be a natural catastrophe-based stress test. This proposed Terror PML will be calculated for three tiers of locations (again based on the information provided in the SRQ) and the greater Terror PML of the three tiers will be selected. Although this is not yet finalized, A.M. Best has provided Aon Re Global with an example of how it will work:

*The PML calculation for a given tier = [probability of large attack (10% for all tiers)] \* [the probability it is in tier given attack occurs (60%, 30% and 10% for tier 1, tier 2 and tier 3 respectively)] \* [the number locations in tier with a net of reinsurance and TRIA loss greater than 10% of surplus, net of reinsurance and TRIA] \* [the largest estimated loss in tier] \* [a data quality adjustment for the tier based on the percent of exposures geo-coded]*

A.M. Best will check to ensure that there are no large single exposures that are in remote locations where there may be a large loss that might not be covered by TRIA because TRIA is not triggered. For non-U.S. companies, A.M. Best will review similar data that is available in each specific market.

In addition, for catastrophe exposed companies, A.M. Best will compare Tail Value at Risk (TVaR) to PML ratios to determine relative volatility in extreme events (see exhibit below). Companies higher than the 75<sup>th</sup> percentile for the industry will be held to a higher minimum BCAR to maintain their current ratings.

### HURRICANE

GROSS TVaR/PML		
	PERCENTILE	
	50 <sup>th</sup>	75 <sup>th</sup>
50 Yr	246%	282%
100 Yr	203%	229%
250 Yr	174%	192%
500 Yr	158%	173%
1000 Yr	148%	159%
NET TVaR/PML		
	PERCENTILE	
	50 <sup>th</sup>	75 <sup>th</sup>
50 Yr	459%	429%
100 Yr	514%	544%
250 Yr	381%	435%
500 Yr	274%	311%
1000 Yr	205%	231%

### EARTHQUAKE

GROSS TVaR/PML		
	PERCENTILE	
	50 <sup>th</sup>	75 <sup>th</sup>
50 Yr	573%	625%
100 Yr	556%	570%
250 Yr	425%	461%
500 Yr	260%	282%
1000 Yr	205%	227%
NET TVaR/PML		
	PERCENTILE	
	50 <sup>th</sup>	75 <sup>th</sup>
50 Yr	656%	545%
100 Yr	678%	596%
250 Yr	527%	531%
500 Yr	413%	444%
1000 Yr	282%	310%

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**STANDARD & POOR'S**

Standard & Poor's (S&P) continues to strengthen its focus on Enterprise Risk Management in its ratings assessment, and routinely rates each company's ERM practices as a component of the overall ratings analysis. S&P has indicated that an insurer must demonstrate that it has strong strategic risk management before it can be assessed as having "strong" ERM. S&P is reviewing how companies incorporate cycle management into their strategic risk management decisions in conjunction with the current year's review. S&P believes that the ability to select risks based on an assessment of its relative risk/reward will be a competitive advantage that will help companies operate more successfully across the cycle.

As companies seek to strengthen their risk management, and in particular for European companies facing the implementation of Solvency II, the industry is investing in better risk controls and in the development of economic capital models. The issue currently at hand is that companies have not fully embedded either of these in their strategic management decisions. Until companies can prove that they rely on their risk controls and economic capital models for strategic decisions, S&P will not consider the company as having a strong strategic risk management.

S&P has indicated that 2008 will be a test for insurers to apply in practice its improved ERM framework, given the challenging environment companies are currently facing. Everyone is in agreement that pricing is falling, and S&P believes that in some areas premium pricing is starting to look poor. The continued competitive market will be a difficult test for companies trying to manage the current cycle. S&P believes that if ERM works as expected, the cycle should be shorter and shallower than previous cycles because companies are expected to exit lines more quickly. In addition, companies are starting to benefit from improved management information systems, and have better aligned underwriters' incentives with long-term profitable growth, both fundamentals of ERM. Along with a focus on underwriting controls, these changes should help companies manage the cycle more successfully.

In addition, S&P published an updated analysis of the "European Insurance Sector in Light of the Recent Market Turbulence" in July 2008. S&P highlighted a number of issues that insurers are facing including negative earnings momentum, margin squeeze due to economic and cyclical factors, lower equity and bond values impacting capital adequacy, and lower financial flexibility due to cost and access to capital. S&P reiterated that its ratings attempt to look through these cyclical highs and, therefore, they do not expect widespread downgrades. They did however

note that capital adequacy is lower than in recent years, but still remains largely consistent with the given ratings. S&P noted that balance sheets remain liquid and that insurers are generating positive operating cash flows.

Many companies have been wondering about the sensitivity of S&P's ratings to a further fall in equity markets. S&P is hesitant to comment regarding a specific ratings trigger point for equity market falls. However, S&P notes that they already stress test for falls in equity markets and that a further 20 percent fall in equity markets could potentially lead to isolated cases of downgrades, but it should not be widespread. S&P significantly increased its equity investment charges in its Enhanced model released last year, and also increased other investment charges for items such as concentration risk and volatility risk, so they believe that their capital model sufficiently captures investment risk.

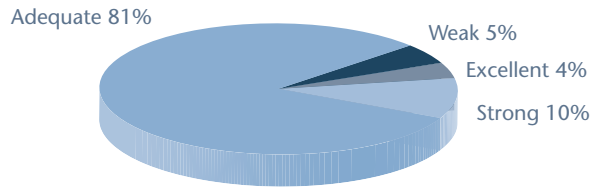
Similar to A.M. Best, S&P believes that the industry is sufficiently capitalized to absorb the current investment losses, so they too are undertaking additional analyses on a case by case basis. Their focus is also on liquidity and financial flexibility, and in addition S&P is reviewing debt covenants and other contractual obligations to determine if companies are nearing a trigger, which if to occur could rapidly deteriorate its financial position.

As a part of the 2008 review, similar to A.M. Best, S&P has said it will look to gain an understanding of the company's cycle management plans. In particular, S&P will review "cycle risk monitoring," including the timeliness of the monitoring and who is responsible for it at each company. In addition, S&P will review a company's trade-off between disciplined underwriting and its growth and/or desired market share. S&P will also be closely monitoring investment management in the context of ERM to determine if the company's strategy (and resulting losses) was in line with expectations. S&P too has stressed the importance of maintaining strong cycle management amid the financial turmoil.

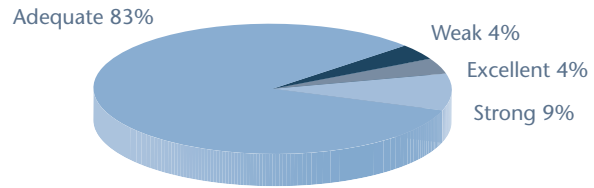
The exhibit on the following page highlights the distribution of ERM ratings across North American/Bermudian and European insurance companies based on 2007 and 2006 rating reviews. There has been very little change in the overall ERM ratings across the regions since the initial assessments began in 2006 (even though the population of ERM rated entities increased). S&P does note that four companies in Europe and two companies in North America/Bermuda were upgraded to "strong" over this time period. In addition, 18 European companies and 15 North American/Bermudian companies have "adequate" ERM with a positive trend or strong risk controls.

## NAVIGATING FINANCIAL STRENGTH RATINGS

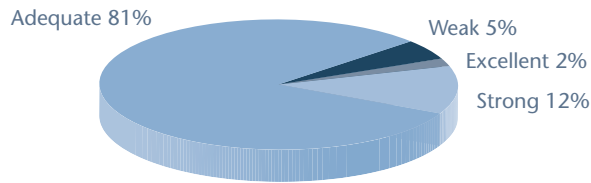
**NORTH AMERICA/BERMUDA 2007**



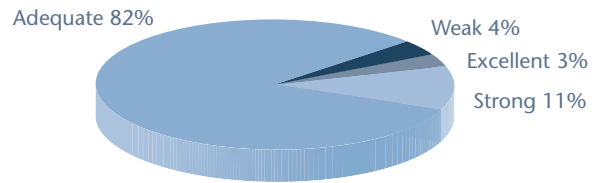
**NORTH AMERICA/BERMUDA 2006**



**EUROPE 2007**



**EUROPE 2006**



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### FITCH

Fitch's current focus is also concentrated on underwriting cycle management, but with a heavier focus on financial flexibility. According to Fitch, the two current main topics in ratings meetings are cycle management and financial flexibility, particularly in the aftermath of the credit crisis. Discussions about ERM continue to be integrated into Fitch's overall rating analysis; however, ERM has featured less heavily in Fitch's recent discussions.

As previously noted, Fitch has increased its focus on companies' financial flexibility in the aftermath of the credit crisis. It is analyzing such topics as: What is the impact on the asset and liability sides of balance sheet? Is a perfect storm brewing? Fitch believes that if the capital and investment markets remain disrupted or decline further and there is a large significant market event or series of events such as Hurricanes Katrina, Rita, Wilma (KRW), there is the potential for a significant liquidity crunch. Companies must demonstrate credible scenario testing for potential simultaneous financial impacts such as a combined investment market and insurance market events. Fitch is asking companies to detail any prearranged credit facilities or alternative sources of capital that would prevent forced selling, and, consequently, a partially avoidable reduction in balance sheet strength. Fitch's concern is that after the event there may be inadequate additional market capital sources for many companies to replenish balance sheet capital, which could trigger a large number of insolvencies and companies forced into run-off.

Fitch is also taking an increasingly hard look at companies' expansion into business lines and markets outside their core areas of expertise, since many insurers with seemingly ancillary exposure to "non-core" credit protection products were materially impacted by 2007 and 2008's credit market dislocation.

Fitch implemented its new stochastic capital model "Prism" in 2007, and has thus far been pleased with its overall results. Similar to S&P's Enhanced model released last year, Prism too included strengthened investment risk capital requirements, and Fitch is therefore comfortable that their model has captured the current volatility and its impact on overall capital. Their current process for analyzing investment risk is in line with A.M. Best, S&P and Moody's.

With the publication of the final 2006 results, Prism scores now form an integral part of Fitch's ratings analysis and will be included in future company reports and commentary. As Prism's platform allows all risks within an insurance organization to be modeled simultaneously and interactively, Fitch believes it is strongly aligned with ERM as the analysis focuses on correlation and diversification among various risk exposures. Fitch anticipates releasing a working copy of its Prism model to the U.S. market later this year and Europe thereafter.

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## MOODY'S

Moody's is also focusing on cycle management, risk management and financial flexibility, and, in addition, has increased its discussions surrounding profitability, as this is broadly seen as under pressure for the sector in the next few years and can put constraints on ratings. The analysts have spent an increased amount of time discussing management of companies' investment portfolios including, for example, exposure to equities as well as sub-prime and other structured asset exposure. Moody's is also reviewing companies' access to new capital (i.e. financial flexibility), noting however that this was already an important component of the rating discussions, and, for many larger groups, remains intact despite volatile markets. Moody's has noted increased

interest in contingent capital facilities and similar products and analysts give some qualitative benefit to such factors when assessing financial flexibility.

From a property and casualty industry perspective, Moody's believes that there is generally pressure on primary lines across Europe. With many groups seeking to manage down expense levels as rate adequacy comes under pressure, Moody's has focused its attention on how companies are extracting expense savings. From a reinsurance perspective, Moody's is particularly focused on how companies are dealing with current pricing and conditions. The expectation is that companies actively manage these risks throughout the current cycle.

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## Enterprise Risk Management Evaluations

### A.M. BEST VIEW

While A.M. Best has increased its focus on ERM, a critical difference from S&P's approach is that A.M. Best firmly believes that ERM is so fundamental to the strength of the insurance organization that it is embedded in every rating component. Therefore, no new separate rating category was established and no separate ERM rating will be issued. Further, A.M. Best clarified its view that while ERM may be a positive development from which all companies can benefit, it is not a requirement for everyone, and that risk management capabilities should be viewed in light of a company's scope of operations and the complexity of its business. This is a welcome clarification for single-line and/or single-state companies who were concerned about the perceived need to hire a chief risk officer. Yet, each company, regardless of its size or complexity, is expected to explain how it measures, monitors and manages risk.

A.M. Best's typical ERM questions have been focused on the following:

- > What are your top five exposures relative to capital and surplus?
- > Identify the ways you monitor and manage these risks.
- > What is management's financial leverage appetite post cat-event?
- > Do you use ERM modeling?
- > How do you capture risk correlations?
- > How do you manage operations through the underwriting cycle?
- > What mechanisms are in place to ensure price and reserve adequacy?

## NAVIGATING FINANCIAL STRENGTH RATINGS

Per its white paper submitted for industry comment in April 2007, A.M. Best has identified the key characteristics of ERM as:

- > Strong risk-aware culture
  - >> Led from the top
  - >> Common language and understanding of risk among managers
- > Identification and management
  - >> Ability to identify and establish controls
  - >> Consistent, corporate-wide guidelines
  - >> Track record of strategic management based on risk tolerances
- > Measurement and monitoring
  - >> Risk/return embedded into management reports
  - >> Scenario-based testing
  - >> Tolerance variance reporting
- > Appropriate level of ERM as a function of size and complexity of company
  - >> "Incorporating selected elements of ERM can help any company regardless of size."

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### STANDARD & POOR'S VIEW

S&P has always strongly emphasized an insurer's risks and how they are managed when forming an opinion of that insurer's financial strength or creditworthiness. Beginning in October 2005, S&P strengthened its emphasis further when it added an explicit and formal evaluation of insurer ERM capabilities to the rating process. According to S&P, ERM is "a highly tailored analytic process that recognizes each insurer's unique structure, products, mix of business, potential earnings streams, cash flows, and investment strategy. It is a process that recognizes the benefits and risks of a diversified base of products, investments, and geographic spread of risk that can quantify the benefits of uncorrelated or partially correlated risks."

STANDARD & POOR'S ERM EVALUATION CHARACTERISTICS				
KEY CHARACTERISTICS	EXCELLENT	STRONG	ADEQUATE	WEAK
Capability to identify, measure, & manage risk	Extremely strong	Strong	Process exists, but is not comprehensive	Limited capabilities
Development of loss/risk tolerance guidelines	Developed	Developed	Less developed	No risk management framework
Losses beyond tolerance guidelines	Extremely unlikely	Unlikely	More likely, especially in areas beyond the scope of current ERM practices	Can be expected
Optimizing risk-adjusted returns	Consistent evidence	Some evidence	No evidence	No evidence
Risk & risk management considerations in decision making	Always important considerations	Important considerations	Often important considerations	Not regularly considered, or new risk management system is untested

Additionally, S&P has formulated an approach for evaluating Economic Capital Models (ECM), which was the third and last phase of its ERM initiative. S&P has indicated that a company must have a strong or excellent ERM rating in order for S&P to review the internal economic model and consider it in the rating review. In addition, the company must have robust risk control processes that are adaptive to changing market conditions.

In order for S&P to give capital credit to the ECM (i.e. possibly allowing the company to operate at a level of capital lower than what is indicated in the S&P factor-based Capital Model), it must be incorporated into the financial management processes and the model must also have significant predictive capacity. The ERM

program must have the discipline needed to ensure that the risk position calculated by the ECM always stays current. Further, the modeling process must have sufficient rigor to develop reliable estimates of the risks of the insurer. The company must demonstrate extensive back testing and stress scenario testing of the ECM, and the models must have demonstrable improvements in accuracy compared to the broad, factor-based “risk based capital” calculations. Finally, the ECM result must be relied on by the insurer, together with other measures, to significantly influence the major decisions of the enterprise. For insurers who do not satisfy these three conditions, the S&P capital adequacy model will be the sole quantitative tool used to measure the capital adequacy of the insurer.

S&P’s nine areas of ECM review:

#### 1. Risk Quantum

- > Risk metrics, accounting conventions, tax, aggregation (VaR - Value at Risk, TVaR - Tail Value at Risk), cycles, time horizon

#### 2. General Risk Levels

- > Market, credit, FX risk, treatment of earnings, discounting, operational/legal/regulatory

#### 3. Specific Risk Levels

- > Track record, modeling unique aspects of company’s risk profile

#### 4. Specific Risk Exposures and Offsets

- > Products, Size, markets, products, distribution, reinsurance, Asset Liability Matching (ALM)

#### 5. Diversification Benefits

- > Reality and modeling approach, tail vs. average correlation, source of assumptions

#### 6. Model Robustness

- > Granularity, parameter risk, feedback loops, materiality

#### 7. Model Execution

- > IT and infrastructure support, documentation, validation and review

#### 8. Model Usage

- > Planning, strategic (buy/exit) decisions, ALM strategy, update frequency, compensation

#### 9. Sensitivity Testing

- > Stress tests applied on key parameters, detailed and summary outputs

## Conclusion

With ratings criteria and methodology constantly evolving to incorporate current market conditions and risks, it is vital for insurance companies to stay abreast of these changes and consider the ultimate impact on their rating. With this current soft cycle, rating agencies’ expectations have been elevated and companies are expected to demonstrate, through actionable steps and results, how their business is being managed through this cycle while maintaining the company’s overall strategy and goals. Companies should not underestimate the importance of Enterprise Risk Management and Cycle Management at all times, but particularly now as they enter into this year’s rating review.



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