NEWSLETTER
RISK MANAGEMENT

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Why Does the Upside of Risk Management Matter for Insurers' S&P Ratings?

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Standard & Poor's Ratings Services considers that the role of enterprise risk management (ERM) is not only about having a framework and process to assess and control the downside of insurers' risk exposure; ERM is also about using the insights drawn from risk analyses to understand the upside of taking risks and managing exposure towards the best-rewarded risks within risk appetite constraints and available financial resources. We consider this to be an important part of effective management for insurers and we incorporate it into our rating analysis. Insurers with the most effective processes to optimise risk return should, over time, deliver higher risk-adjusted returns. The ability to outperform peers is a favourable factor in our rating analysis.

How S&P analyses the upside of risk management

Strategic risk management (SRM) forms a part of our ERM assessment, which is one of the factors determining ratings on insurers. While other aspects of our ERM analysis mainly focus on limiting the downside, SRM is also about the upside of risk management. It covers insurer's capabilities to optimise risk-adjusted returns and to prioritise strategic options consistently. The analysis focuses on the risk/reward rationale underlying the insurer's chosen strategy. It incorporates evidence of where the insurer has made strategic decisions using economic risk/reward metrics that are consistent with its risk appetite, and considers how an insurer balances other concerns, including regulatory and accounting considerations.

We assess SRM as positive, neutral or negative for all rated insurers. A positive SRM assessment is required (in addition to positive assessments in other key ERM factors) for a strong or very strong ERM assessment—these are the highest ERM assessments under our ratings criteria.

The SRM assessment is positive if the insurer executes consistent and effective risk/reward analysis in most of our key areas of analysis, including the company's strategic planning; product pricing and repricing; strategic asset allocation; reinsurance strategy and net retained risk profile; new risk-bearing initiatives (including mergers and acquisitions or entry into new markets); capital, or economic capital budgeting; and optimisation of risk-adjusted returns.

The score is positive only if an insurer demonstrates a history of successful execution of its strategic risk management programme, including, for example, better-than-peer risk-adjusted returns and a track record of successful mergers and acquisitions that is consistently accretive on a risk-adjusted basis.

We assess SRM as a neutral factor when an insurer uses some risk/reward analysis in decision-making, but applies the metrics and processes inconsistently across the company. The score could also be neutral if an insurer has developed an economic capital model and uses model results in the strategic risk management process, but the economic capital model has limited history or credibility.

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When risk and risk/reward analysis is not adequately reflected in the insurer's decision-making, we assess the SRM as negative.

Consistent risk/return metric is key

We consider the key element for an effective SRM is to have a robust risk-adjusted profitability metric, with the risk element of that metric consistent with the insurer's economic capital model. We have observed that insurers not employing SRM usually fail to do so because they do not have a common measurement basis across all of their risks. Many insurers have recently moved to develop economic capital models, which provide a powerful tool that can be used as the common risk measure for SRM. While economic capital is most often the metric used to define risk in the risk/reward equation of SRM practitioners, economic capital by itself does not indicate that SRM is executed by an insurer.

A key challenge for insurers is to demonstrate that risk-adjusted profitability metrics are appropriate for different lines of business, covering both life and non-life, and business units operating under different regulatory and accounting regimes. Also, they need to be accepted by the decision-makers and recognised as adequately capturing the risk exposures and return characteristics of the exposure under consideration.

SRM starts with the planning process

In our view, a critical feature of positive SRM is that risk-adjusted metrics are explicitly used in the strategic planning process to inform the future business mix and risk profile. We review the process insurers follow in their strategic planning to determine an optimum risk/return profile within its risk appetite.

We recognise that a mathematically optimised business and risk portfolio may be not be achievable in practice, and it is not realistic to expect that an insurer could significantly change its risk profile year-on-year. Nevertheless, in our analysis, we review how insurers adjust the business mix in response to material changes in the risk characteristics and the expected risk-adjusted profitability of different lines.

In our SRM assessment, we also focus on the process an insurer follows to monitor the risk-adjusted profitability it achieves, relative to the planned profitability targets. An insurer's pricing adequacy monitoring systems play a key role in that process. We see more extensive development and use of pricing adequacy monitoring systems for both life and non-life business. We observe that many companies have enhanced these systems to improve the consistency of measuring the profitability of different business lines relative to internal targets. Combined with improvements in the allocation of capital, this affords greater accuracy in determining the cost of capital used in these internal targets.

Our assessment of pricing adequacy systems does not just focus on their level of sophistication. In our assessment, it is also important to consider how insurers use these systems to improve the risk/return profile of their business by enforcing adequate pricing relative to the specific risk and capital characteristics of different lines of business. We recognise that it can be difficult to develop and apply such a system in practice, and in our discussions with insurers we focus on how they allow for their system's limitations.

We also consider in our SRM assessments how insurers address underperforming business units and product lines, in particular, whether an insurer has a clear plan to address the causes of the underperformance, or even to exit a segment of the market if the competitive environment over the strategic horizon will restrict the ability of the insurer to achieve an adequate return. We do not view favourably an insurer that tolerates underperforming lines solely to maintain its market share.

Optimising asset allocation and reinsurance protection

Our SRM assessment also incorporates whether strategic asset allocation (SAA) and reinsurance programme design utilise extensive risk/return analysis. We recognise that full optimisation may not be practical and other considerations also matter (for example, the stability of asset allocation and reinsurance programme).

While the use of risk/return optimisation for determining SAA has been more widely used in the industry, we observe that some insurers also have in place more-sophisticated approaches for designing their reinsurance programmes. A number of insurers employ internal models to regularly assess the value of these reinsurance programmes to optimise their risk/return profile. These assessments aim to measure an insurer's own view of its risk exposure against current market prices and conditions to manage its risk profile relative to its risk appetite, while at the same time optimising the costs and benefits of the reinsurance protection. Also, some insurers have been utilising the widespread availability and value of alternative risk-transfer instruments, such as insurance-linked securities (ILS) and sidecars. While we accept that qualitative considerations such as stability in the reinsurance programme and the importance of maintaining good relationships with reinsurers remain important, we view positively the increasing use of sophisticated quantitative analysis in designing those programmes.

Standard & Poor's believes that an insurer that practices SRM is, over time, more likely to make choices that maintain and improve its underlying profitability, while staying within its risk tolerance.