

Enterprise Risk Management Framework: Is It Working Effectively or Is It Window Dressing?



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Introduction

- Regulators and Rating Agencies Expect Companies of All Sizes to Implement an Enterprise Risk Management Framework
- Small to Mid-Size P&C Insurance Companies are Spending Considerable Time and Resources Attempting to Comply
- Fundamental Operating Practices May Not be in Place to Support an Effective ERM Framework
- An ERM Framework Without Fundamental Operating Practices in Place is Analogous to...



Do You Have Fundamental Operating Practices to Support Your Key Risks?

Key Risk	GAP in Operating Practices
Pricing	No Price Monitoring Reports to calculate rate level changes
Loss Reserves	No Internal Quarterly Reserve Indication Review No Setting of IBNR Reserves Other Than Annually by Outside Opining Actuary
CAT Management	No Interim Review of Property Exposure Following Annual RMS/AIR Modeling by Reinsurance Broker
Delegation of Underwriting Authority to Agents or Underwriters	No Written Underwriting Authority Statements No Underwriting Quality Assurance Process
Investment Portfolio	No Risk Metrics (Only Return Metrics Utilized)
Rating Agency Downgrade	No Financial Forecasts of Balance Sheet or Capital Adequacy

Agenda

- Definition and Components of ERM Framework
- Operating Practices to Support Management and Mitigation of Key Risks:
 - Common Risk Factors for P&C Insurance Companies
 - Five Characteristics of an Operating Practice
 - Sample Fundamental Operating Practices:
 - Pricing
 - Loss Reserves
 - Property Catastrophic Events
 - Claims Handling
 - Investment Portfolio



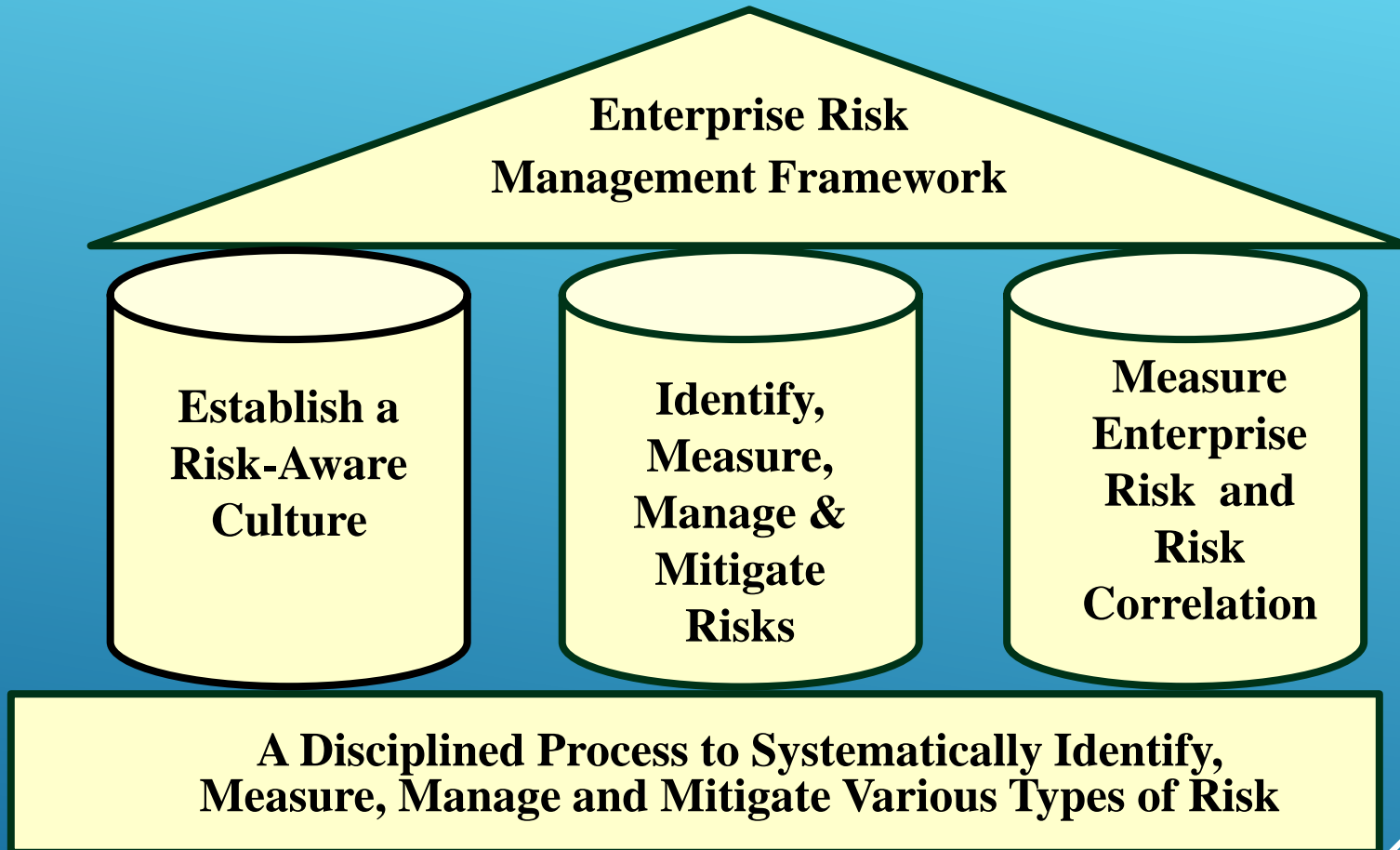
ENTERPRISE RISK MANAGEMENT (ERM) FRAMEWORK

What is Enterprise Risk Management?

“The culture, capabilities and practices, integrated with strategy setting and its execution, that organizations rely on to manage risk in creating, preserving and realizing value.”

*Enterprise Risk Management: Aligning Risk with Strategy and Performance
Committee of Sponsoring Organizations of the Treadway Commission
(COSO), June 2016*

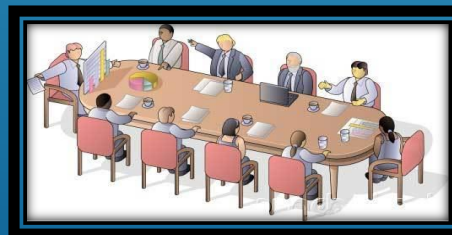
What is an ERM Framework?



Establish a Risk-Aware Culture

ERM Tone Established by Board and Senior Management

1. ERM Roles and Responsibilities clearly defined
2. Define Risk Profile, Risk Appetite and Risk Tolerance Levels
3. Mission, Strategic Goals, Core Values and ERM documents shared with all employees
4. Executive Performance Reviews and Compensation Includes ERM Objectives and Results
5. Transparent Risk Reporting and Communication Throughout Company From Employees Through Board of Directors



Benefits of an ERM Framework

- Evaluates Capital Adequacy to Achieve Long-Term Strategic Goals
- Reduce Level of Earnings and Capital Volatility
- Sustain a Consistent Level of Operating Profitability
- Improve Operating Efficiency and Effectiveness
- Create a Risk-Aware Culture Encouraging Prudent Risk-Taking
- Develop Consistent Metrics to Measure and Monitor Risk Tolerance Levels
- Increase Accountability Throughout Organization
- Maintain Excellent Ratings from Rating Agencies



OPERATING PRACTICES TO SUPPORT MANAGEMENT AND MITIGATION OF KEY RISKS

Common Risk Factors for P&C Insurers

Credit	Market
<ul style="list-style-type: none"> ▪ Bond Issuer Default/Downgrade ▪ Agency/policyholder credit risk ▪ Reinsurer default ▪ Currency 	<ul style="list-style-type: none"> ▪ Liquidity ▪ Interest Rate/Reinvestment ▪ Common Stock Market Price
Underwriting	Operational
<ul style="list-style-type: none"> ▪ Product Development ▪ Regulatory ▪ Catastrophic Event ▪ Loss Reserve ▪ Pricing ▪ Emerging Loss Exposures 	<ul style="list-style-type: none"> ▪ Data Capture/System Security ▪ Loss of Key Personnel/Employee Turnover ▪ Fraud/Financial Controls ▪ Claim Handling ▪ Delegation of Underwriting Authority ▪ Financial Reporting ▪ Disaster Recovery and Business Continuity
Strategic	
<ul style="list-style-type: none"> ▪ Rating Agency Downgrade ▪ Industry Competition ▪ Economic Downturn 	<ul style="list-style-type: none"> ▪ Reputation ▪ Capital Availability ▪ Competitor technology

Operating Practices Should Support Each Key Risk Factor

Sample (Catastrophe Event Risk) – 12/31/2016

Description of Risk: <i>The Company has a concentration of property values in the state of Pennsylvania that could produce a loss in excess of the Company's catastrophic event reinsurance program.</i>		Oversight: <i>Audit & Risk Committee</i>		Frequency of Oversight: <i>Annually</i>
Risk Owner: <i>Vice President - Underwriting</i>		Risk Tolerance Level: <ol style="list-style-type: none"> <i>Net Pre-CAT PML Loss will not exceed \$75.0 million (1:100 year return time).</i> <i>Total property values in 125 mile concentric circles will not exceed \$.9 bil.</i> 		Risk Score: <ol style="list-style-type: none"> <i>As of December 31, 2016, the Company's Net Pre-CAT PML was \$69.5 million.</i> <i>Not able to be measured as of 12/31/2016.</i>
Risk Mitigation Strategy/Control Activity: <ol style="list-style-type: none"> <i>The Company completes RMS and AIR property modeling four times a year.</i> <i>Gross total property values by zip code and construction are reviewed monthly.</i> <i>Property guidelines outline the Company's willingness to write property based upon construction, occupancy, protection class and exposure.</i> 		Date & Result of Testing: <ol style="list-style-type: none"> <i>Property modeling completed as of 11/30/2016.</i> <i>No testing completed.</i> <i>No testing completed.</i> 		Control Effectiveness: <ol style="list-style-type: none"> <i>Strong</i> <i>Weak</i> <i>Moderate</i>
Impact/Severity of Event (Low 1 to High 6)	5	Likelihood / Frequency of Event (Low 1 to High 6)	4	Issues for Remediation: <ol style="list-style-type: none"> <i>Develop monthly property value reports to address Control Activity #2.</i> <i>Develop an underwriting quality assurance process to address Control Activity #3.</i>
Status: 12/31/2016: <i>In compliance with RTL #1 (1:100 year return time). No progress on implementing control activities #2 or #3. Management has established a 3/31/2017 goal to implement an underwriting quality assurance process and 6/30/2017 to produce monthly property reports to address Control Activity #2.</i>				Change from Last Quarter: <i>No Change</i>

Five Characteristics of an Operating Practice



- Availability of Data and Information
- Management Establishes Risk Tolerance Levels
- Disciplined Process Designed and Implemented to Ensure Operating Practice is Executed
- Periodically, the Disciplined Process is Independently Reviewed
- Weekly/Monthly/Quarterly Reports Produce Risk Performance Metrics to Validate Effectiveness of Operating Practices and Shared with Management

SAMPLE FUNDAMENTAL OPERATING PRACTICES

Pricing Operating Practices

- Actuarial Pricing Reviews Performed Annually for All Products and Lines of Business
- Pricing Metrics Produced to Track Annual Rate Level Change, Manual Rates Levels and Use of Discretionary Pricing Tools
- Agents and Underwriters' Authority to Use Discretionary Credits Should be Restricted, Documented and Monitored



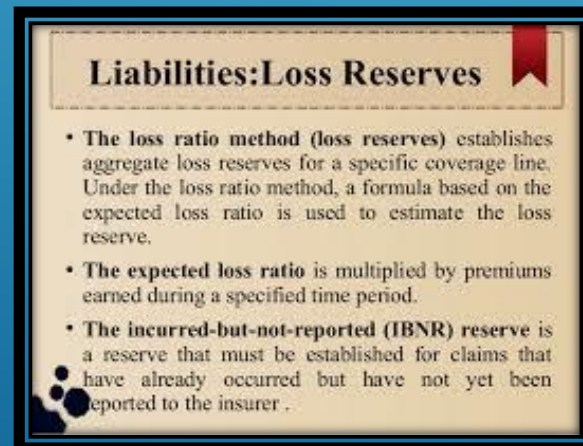
Pricing Operating Practices



	Prior Year			Current Year			% Increase		
	Manual Rate Level	Discretionary Modifications	Actual Price Level	Manual Rate Level	Discretionary Modifications	Actual Price Level	Manual Rate Level	Discretionary Modifications	Actual Price Level
New Business	1.000	0.865	0.865	1.075	0.880	0.946	7.50%	1.73%	7.63%
Renewals	1.000	0.920	0.920	1.075	0.940	1.011	7.50%	2.17%	7.67%
Total	1.000	0.900	0.900	1.075	0.918	0.986	7.50%	1.94%	7.65%

Loss Reserve Operating Practices

- Outside Opining Actuary Performs Annual Reserve Review and Meets with Audit Committee Annually
- Monthly Reserve Booking Process Includes Adjustments to IBNR and Ultimate current and Prior AY Loss & LAE Ratios
- Quarterly Internal Loss Reserve Review Performed



Loss Reserve Operating Practices

Quarterly Internal Loss Reserve Review

- Comparison of *Actual* Case Reserve Development by Line of Business by Accident Year to *Expected* Case Reserve Development

AY	Per Schedule P							Implied LDF @			
	Earned Premium	Paid Loss & DCC	Incurred Loss & DCC	IBNR	Ultimate Booked Loss & DCC	Ult LR Booked	Actual LDF Selected @ 12/31/2016	3/31/2017	6/30/2017	9/30/2017	12/31/2017
2007	\$48,000	\$ 27,000	\$ 27,000	\$ -	\$ 27,000	56.3%	1.0000	1.0000	1.0000	1.0000	1.0000
2008	\$46,000	\$ 32,300	\$ 32,300	\$ -	\$ 32,300	70.2%	1.0000	1.0000	1.0000	1.0000	1.0000
2009	\$43,000	\$ 27,200	\$ 27,200	\$ -	\$ 27,200	63.3%	1.0000	1.0000	1.0000	1.0000	1.0000
2010	\$41,000	\$ 31,000	\$ 31,000	\$ -	\$ 31,000	75.6%	1.0000	1.0000	1.0000	1.0000	1.0000
2011	\$40,000	\$ 53,000	\$ 53,000	\$ 5	\$ 53,005	132.5%	1.0001	1.0000	1.0000	1.0000	1.0000
2012	\$40,500	\$ 32,300	\$ 32,600	\$ 50	\$ 32,650	80.6%	1.0015	1.0012	1.0008	1.0005	1.0001
2013	\$44,000	\$ 23,200	\$ 23,600	\$ 100	\$ 23,700	53.9%	1.0042	1.0036	1.0029	1.0022	1.0015
2014	\$48,000	\$ 32,000	\$ 32,400	\$ 300	\$ 32,700	68.1%	1.0093	1.0080	1.0067	1.0055	1.0042
2015	\$51,000	\$ 27,600	\$ 28,200	\$ 700	\$ 28,900	56.7%	1.0248	1.0209	1.0170	1.0132	1.0093
2016	\$53,000	\$ 23,400	\$ 27,000	\$3,000	\$ 30,000	56.6%	1.1111	1.0895	1.0680	1.0464	1.0248

Catastrophic Property Event Operating Practices



- Property Exposures Modeled Twice per Year Utilizing RMS and AIR Models
- Annually, Model Risk is Evaluated by Reviewing Property Data Reported to Model Data Requirements
- Total Insured Values are Aggregated by County/Zip Code and Reviewed for Wind Exposure Growth
- Average Annual Loss (AAL) to Premium Ratios are Reviewed to Ensure Rates Reflect Property CAT Loss Exposure
- Property Wind Guidelines are Published and Monitored
- Catastrophic Vendor Claim Contingency Response Plan
- CAT Reinsurance Limits and Retentions Selected Based Upon Impact on Capital Adequacy

Claims Handling Operating Practices

- Claims Best Practices and Claims Procedures Manual
- Claims Quality Assurance Process
- Litigation Management Guidelines
- Early Intervention in Special Investigation Unit (SIU) and Subrogation Processes
- Reservation of Rights and Coverage Denials Letters Restricted
- Claims Watch List Used to Monitor Complex Claims
- Process to Review Claims at Initial Reserves/Inactive Claims
- Disciplined Claim Vendor Management Process
- Claims Examiners have Written Authority Statements



Investment Risk Factors for P&C Insurers



Key Risk Factor	Definition
<p>Bond Issuer Default/Downgrade</p>	<p>Bond issuer default or downgrade resulting in an impairment charge or decrease in the market value of fixed income securities.</p>
<p>Liquidity Risk</p>	<p>The inability to convert assets into cash with no cost or asset value decrease in order to pay liabilities and expenses as they become due.</p>
<p>Interest Rate Risk</p>	<p>(1) An increase in interest rates resulting in a decline in the fair market value of fixed income securities. (2) A decline in interest rates resulting in proceeds received in the future may have to be reinvested at a lower potential interest rate (Reinvestment Risk)</p>
<p>Common Stock Market Price</p>	<p>Common stock investments are subject to market volatility resulting in decline in the carrying value of common stocks and a decline in surplus.</p>

Investment Portfolio Operating Practices

Investment Guidelines Include:

- **Authorization** – Creation of Board Investment Committee; Amendments require board approval; transactions approved by Committee quarterly.
- **Policy Statement** - Managed in a conservative, risk-adverse style with the goal of maximizing after-tax total return on equity, while producing a stable level of after-tax investment earnings and maintaining safety of principal and preservation of capital.
- **Objective** - Maintain an appropriate level of liquidity to satisfy the current cash requirements; Protect the Company's assets from excessive volatility in fluctuations in their market value; Meet insurance regulatory requirements.
- **Portfolio characteristics** –Allocation by fixed income, cash and equities (including BA Assets and non-investment grade fixed income); average credit quality; duration; fixed income allocation by sector; equity security characteristics; diversification restrictions, performance benchmark and risk benchmark.
- **Asset/Liability Management** – The relationship of the allocation and duration of fixed income investments to the amount and duration of liabilities.

Investment Portfolio Operating Practices

Quarterly Review of Investment Portfolio with Investment Asset Manager:

- Review of Economy & Outlook and Fixed Income and Capital Markets
- Investment Performance Gross and Net of Fees Versus Benchmark with Attribution Analysis
- Risk metrics:
 - Efficient Frontier
 - Earnings risk (standard deviation)
 - Capital risk (Probability of a x% loss of capital using TVAR at selected confidence level for a specific time horizon) (ex.; 25% probability of a 10% loss of surplus at 99.5% TVAR, one year out)
 - Interest Rate/Credit Scenario Analysis – 100 / 200 / 300 BP movement in interest rates

Quarterly Review of Investment Portfolio with Investment Asset Manager (Continued):

- Portfolio Characteristics Versus Guidelines and Rolling Four Calendar Quarters
- Investment Guideline Compliance Review
- Rating Agency Credit Quality Upgrades/Downgrades and Watch List Actions During Most Recent Quarter
- Investment Transactions During Most Recent Quarter
- Portfolio Holdings by Security

Summary

- Numerous Benefits of Implementing ERM Framework for All Size Companies
- For Small to Mid-Size Insurers With Limited Resources, it is a Major Undertaking; Process Should Begin Immediately
- Develop Fundamental Operating Practices and Risk Performance Metrics for Each Key Risk
- Insurers Can Obtain Value From ERM Framework and Facilitate Next Financial Examination Process

ANY
QUESTIONS
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Joseph F. Morris, CPA, MBA Bio



Joseph F. (Joe) Morris, CPA, MBA, has over thirty-six years of insurance industry experience. Joe founded P&C Insurance Company Strategies, LLC (PCIC Strategies) in 2013, but between 2014 and 2016, he led American European Insurance Group, a B-rated regional admitted insurance company to operating profitability in 2016. Prior to founding PCIC Strategies, Joe was President and CEO of three property and casualty insurance companies: Stonecreek Specialty Underwriters, LLC, a wholly-owned excess & surplus lines subsidiary of Selective Insurance Group, Inc., James River Insurance Company and The Philadelphia Contributionship. From 2000 through 2006, Joe also held several positions with United America Indemnity, Ltd. (UAI) including President & CEO of Penn-America. Joe began his insurance career at Reliance Insurance Company where, over a twenty-one year career, he held a number of financial and operating positions.

Joe has been a member of the Board of Directors of The Insurance Society of Philadelphia since 1989 and was its Chairperson in 1997-1999.

PCIC Strategies provides business and financial services to property and casualty insurance companies with a specialization in assisting companies in developing and implementing an enterprise risk management framework.

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