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ERM a value creator or destroyer? A rating agency perspective

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Agenda

1. ERM a rating agency perspective
2. ERM and business strategy
3. ERM and investments
4. ERM and retention and profitability
5. Conclusion

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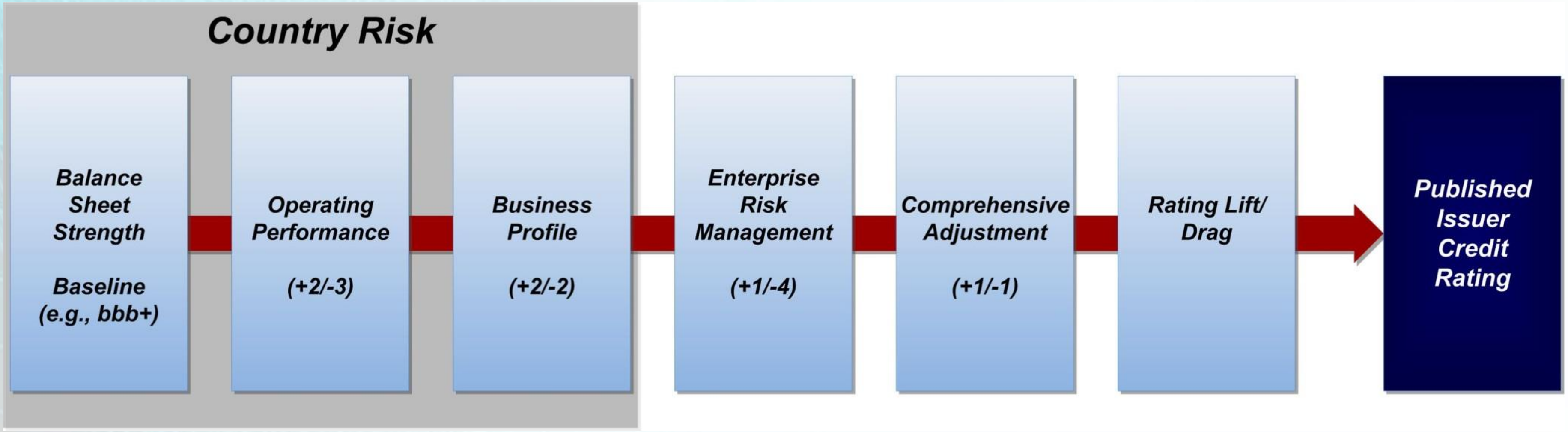
A.M. Best rating methodology – key rating components

Upcoming Changes to Methodology - Draft BCRM

- Moving to a building block approach
- Key elements of the analysis do not change

A.M. Best's Rating Process



Play: guess the rating

	Balance Sheet Strength	Operating Performance	Business Profile
Company A	**$100m** capital Risk adjusted capitalisation: **good**	**$10m** profit Combined ratio: **100%** Loss making once every 5 years	Leading position **$150m** GWP
Company B	**$100m** capital Risk adjusted capitalisation: **excellent**	**$5m** profit Combined ratio: **90%** Always profitable	Leading position **$120m** GWP
Company C	**$100m** capital Risk adjusted capitalisation: **average**	**$10m** profit Combined ratio: **100%** Always profitable	Leading position **$150m** GWP

Risk Management in the Rating Evaluation Process

Risk Management decisions are evident in the balance sheet strength, operating performance, and business profile

Risk Management = (Identify + Understand + Measure + Manage) Risk

ERM

Q: What is ERM?

A: The process through which insurers identify, quantify and manage risk on an enterprise-wide, holistic basis

ERM takes into consideration the individual risks at hand, as well as any correlations and inter-dependencies of risk across the entire organisation

Risk profile for insurers

RISK PROFILE

HIGH RISK
MODERATE RISK
LOW RISK
MINIMAL RISK

RISK PROFILE DEPENDS ON:

- Line and type of business
- Market profile (growth, competition etc)
- Investments
- Liquidity
- Operating environment (regulation, legislation etc)

Matching risk profile to ERM capabilities

RISK PROFILE		ERM CAPABILITY
HIGH RISK	⟷	SUPERIOR
MODERATE RISK	⟷	STRONG
LOW RISK	⟷	GOOD
MINIMAL RISK	⟷	WEAK

Evaluating risk profile and ERM capabilities

Risk profile		ERM
HIGH RISK		SUPERIOR
MODERATE RISK	POSITIVE RATING FACTOR ERM well above risk profile	STRONG
LOW RISK	Potential lower capital requirements	GOOD
MINIMAL RISK		WEAK

Evaluating risk profile and ERM capabilities

Risk profile

HIGH RISK

MODERATE RISK

LOW RISK

MINIMAL RISK

NEGATIVE RATING FACTOR

ERM well below risk profile

Potential higher capital requirements

ERM

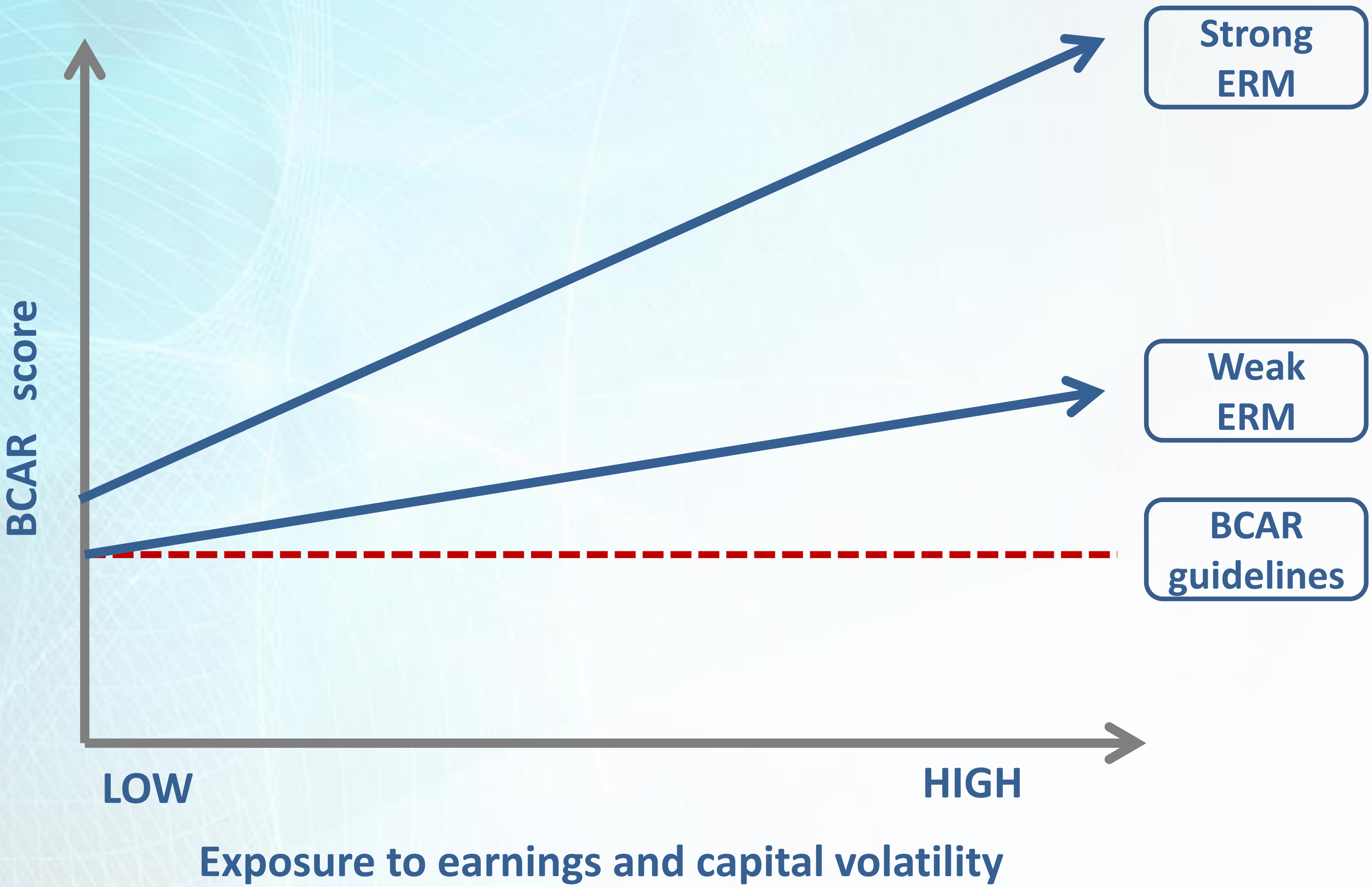
SUPERIOR

STRONG

GOOD

WEAK

ERM and BCAR


Strong ERM
Weak ERM
BCAR guidelines
BCAR score
LOW
HIGH
Exposure to earnings and capital volatility

Common comments

Our company has low risk profile – see our results

You cannot measure risk profile

ERM is good for developed markets - it doesn't apply here

ERM means we will never make any profits

How can one measure ERM capabilities

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Risk profile – line of business

Line of business	Policy limits	Correlation of lines
HIGH RISK Excess Long tail liability (WC, Occ) Cat exposed	**HIGH RISK** High limits (over $1m) (over 10% of PHS)	**HIGH RISK** Highly correlated movement in losses, especially in tail
MEDIUM RISK Medium tail liability (Prof, CM) Non-cat prop (HO, Cprop)	**MEDIUM RISK** Moderate limits ($100k to $1m) (1% to 10% PHS)	**MEDIUM RISK** Independent movement in losses
LOW RISK Short tail liability (motor) Motop physical damage Small value property	**LOW RISK** Low limits (under $100k) (under 1% of PHS)	**LOW RISK** Negative correlation Natural hedges

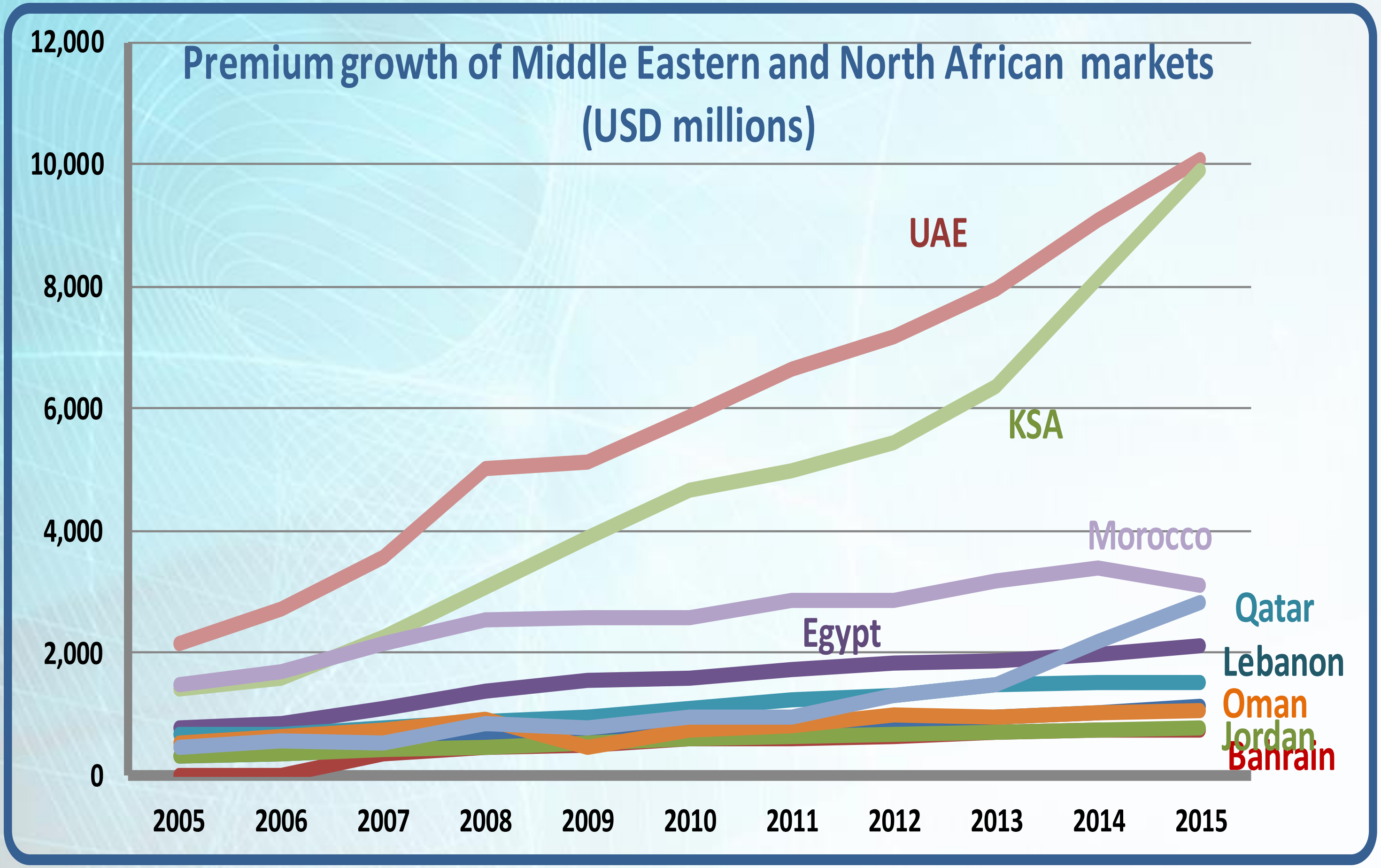
Indicates average ME market

Risk profile – product growth and concentration

Concentration	Growth	Product / coverage changes
HIGH RISK High concentrations Line, region, agent, etc	**HIGH RISK** New line, new areas New country, new agents Excessive level of growth Inadequate expertise	**HIGH RISK** Frequent changes Multiple coverage options Manuscript policies Complex, untested
MEDIUM RISK Some concentrations in portions of operations	**MEDIUM RISK** New product in existing line but with current agents Management expertise in growth lines / jurisdictions	**MEDIUM RISK** Occasional changes Few coverages offered Standardised policies
LOW RISK No concentrations	**LOW RISK** Stable sustainable growth In line with economic growth Growth in existing line / areas Favourable rate environment	**LOW RISK** Minimal changes Limited coverage options Standardised, legally accepted / proven policies

Indicates average ME market

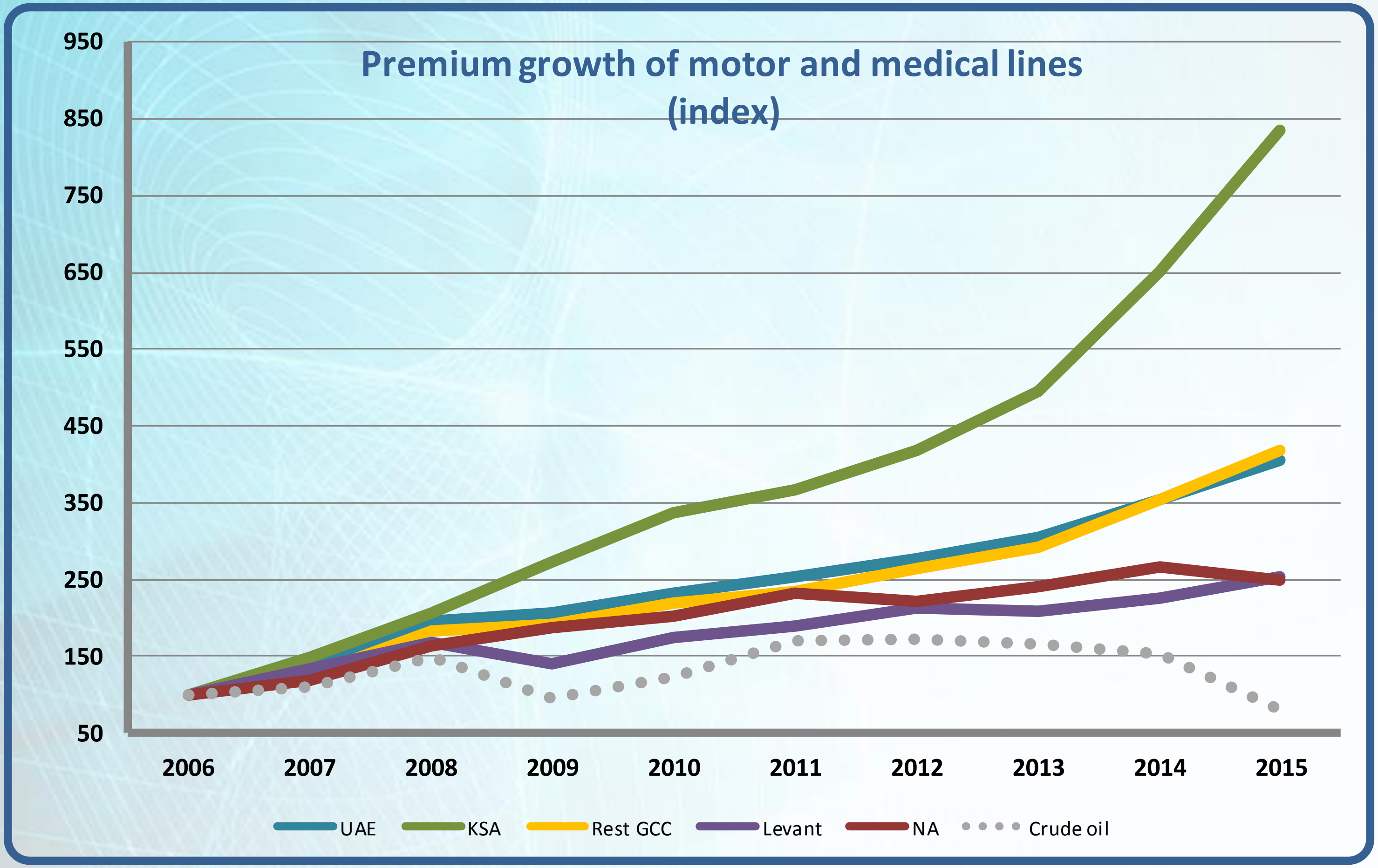
Main insurance markets in the Middle East have continued their strong growth



Source: Swiss Re Sigma reports

- UAE and Saudi Arabia are the largest insurance markets in MENA
- These together with Qatar (from 2013 onwards) have been the main growth markets in the region
- Introduction of compulsory covers and price increases have been critical to market growth

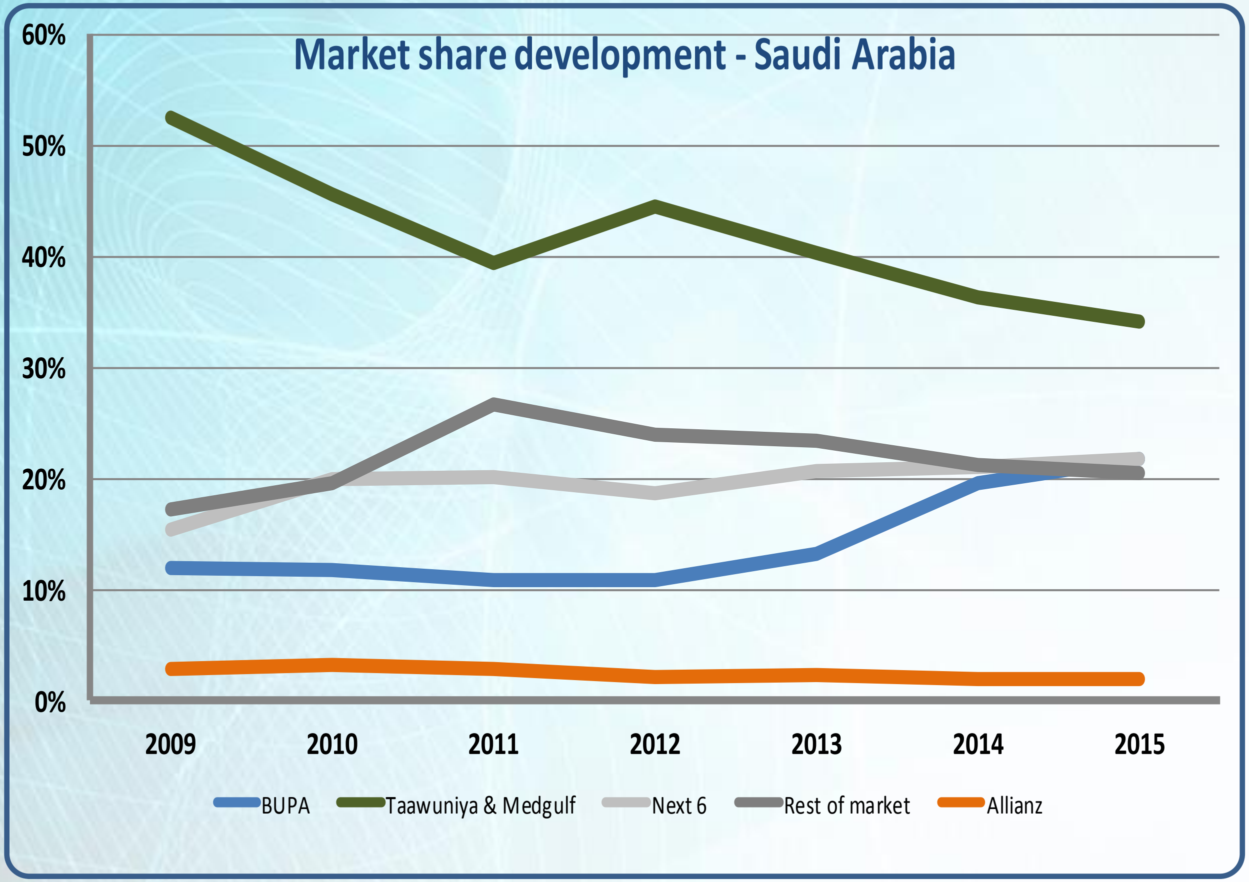
Motor and medical are the main growth lines



Source: Swiss Re Sigma, Central Bank of Bahrain (CBB), Egyptian Financial Services Authority (EFSA), Jordan Insurance Federation (JOIF), Saudi Arabian Monetary Agency (SAMA), UAE Insurance Authority, US Energy Information Administration (EIA) A.M. Best analysis

- Motor and medical have grown much faster than the market average in most markets
- Growth of these lines has continued unabated even in years of declining oil prices
- Introduction of compulsory covers combined with rate increases seem to be the main drivers of growth
- Most companies have been following the same strategy focusing on all lines of business

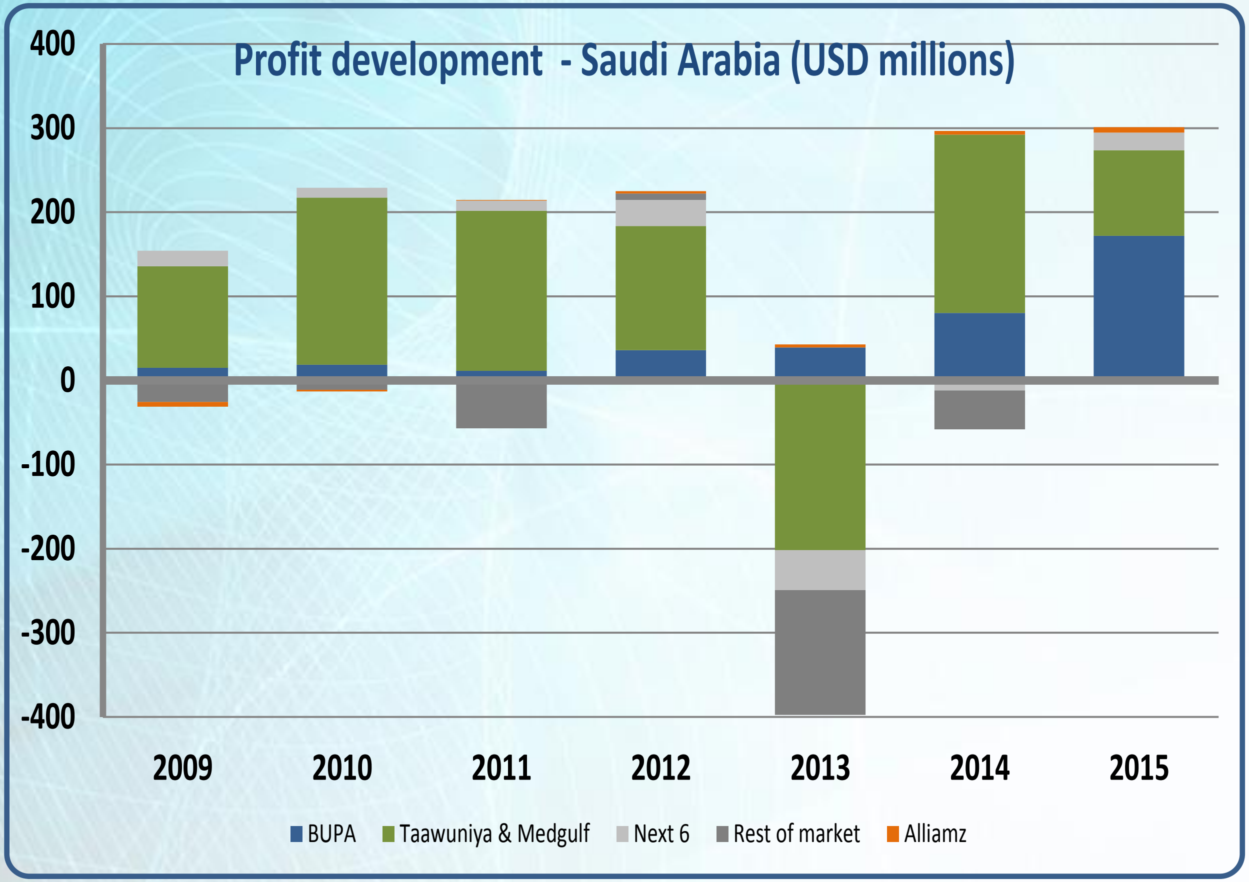
Market strategy: focusing on specific segments . . .



- Saudi market is dominated by 3 large insurers writing almost 60% of total premiums
- BUPA focusing on medical insurance has double its market share to 20% in 7 years
- Allianz focusing on SMEs has had a stable market share of 3%
- Most other companies in the market focus on all product lines and segments. Their market shares are stable or reducing

Source: A.M. Best Statement File Global database

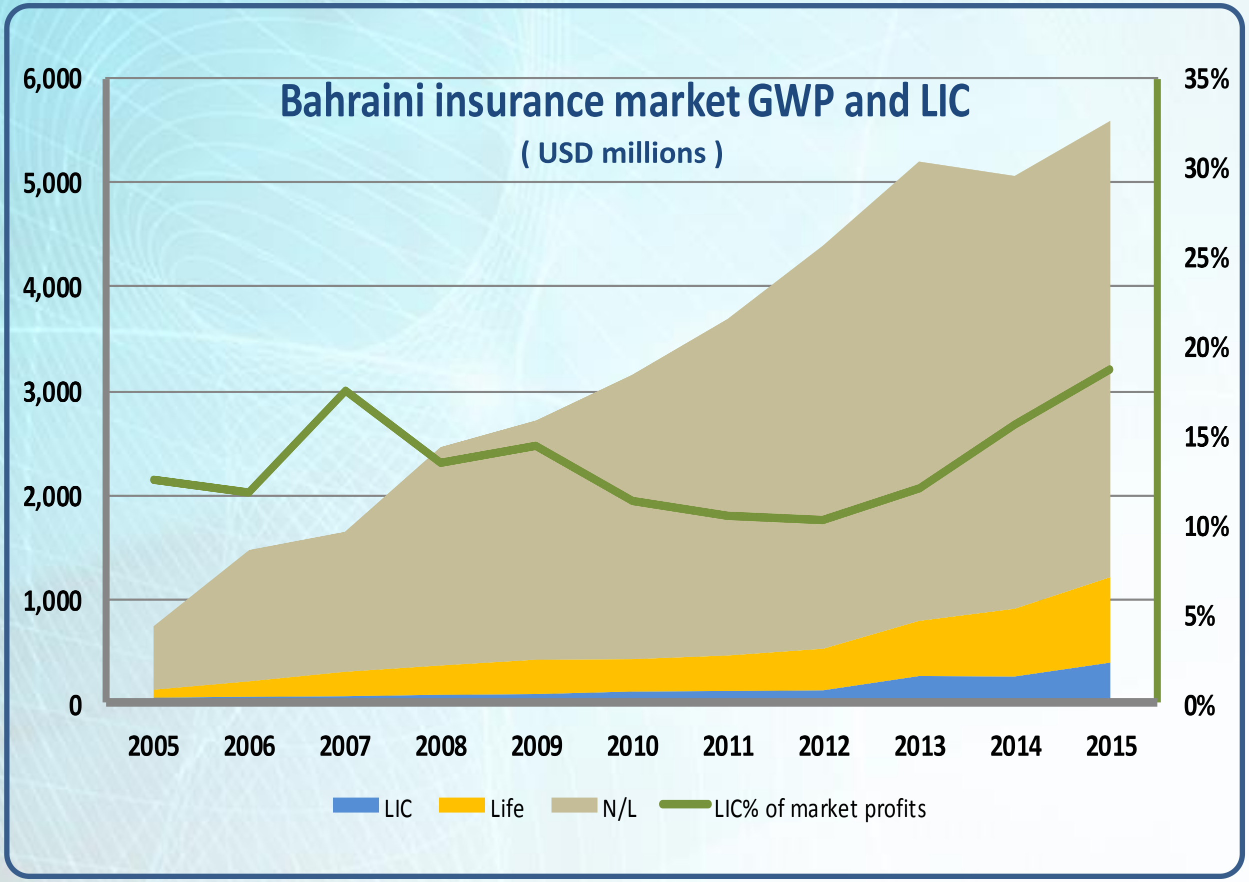
. . . results in outperforming market in profitability



Source: A.M. Best Statement File Global database

- Strategies of BUPA and Allianz are different and require different ERM capabilities
- Both companies have benefited from the expertise of their parent-companies
- They have both remained consistently profitable in the last 5 years
- They are the only companies in the market with greater proportion of the market profits than their market share

Dominate the segment that others ignore



- Life Insurance Corporation (LIC) is a subsidiary of LIC of India
- Has historically focused on providing life insurance to Indian expats in the GCC
- Life business in Bahrain accounts for only 20% of the market
- LIC is writing 30% of the life premiums reported in Bahrain (or 6% of the consolidated market premiums)
- LIC accounts for 15-20% of the profits reported in the Bahraini insurance market

Source: A.M. Best Statement File Global database

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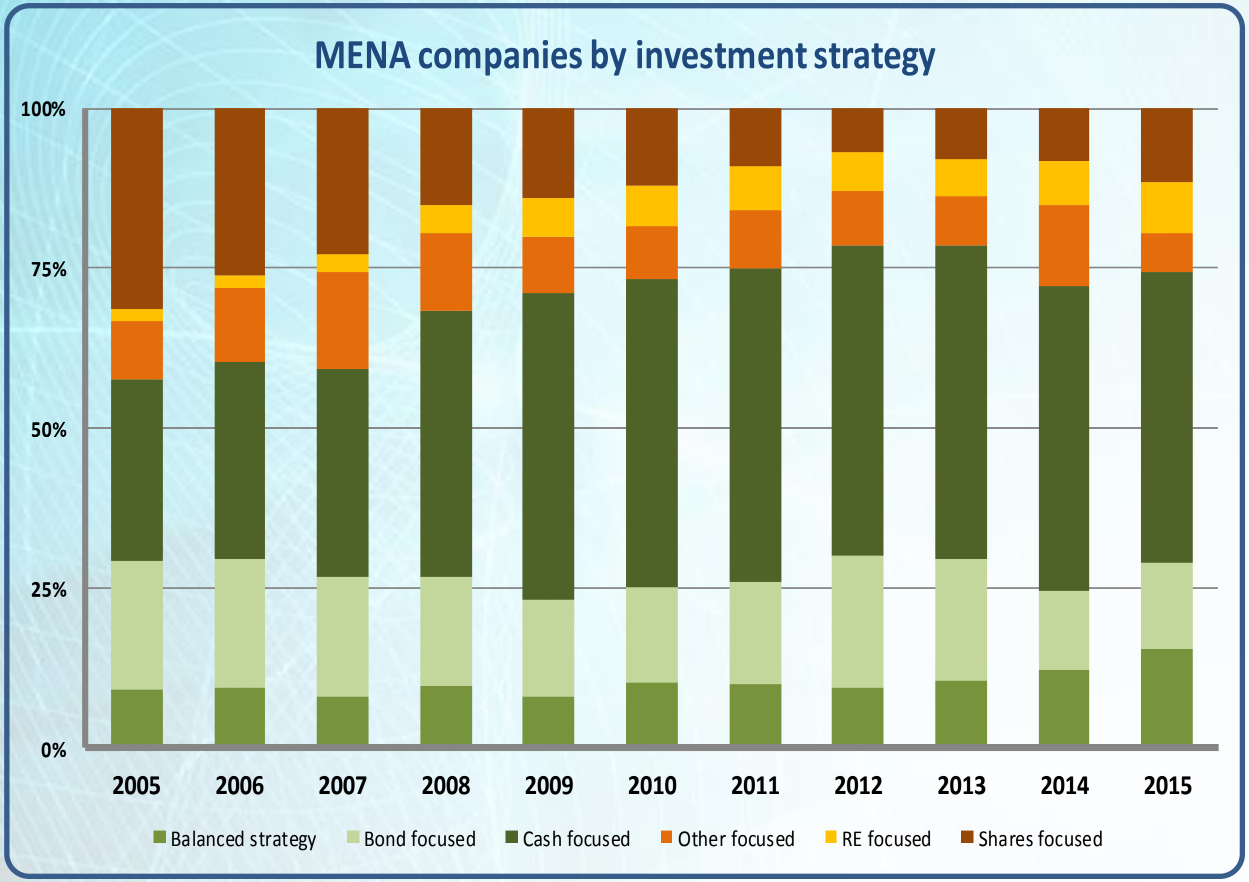
Risk profile – investments and liquidity

Investments	Liquidity
HIGH RISK Low rated fixed income Concentrations, illiquid High % in equities Speculative derivatives	**HIGH RISK** Investment portfolio illiquid No outside sources of liquidity Mismatch in liquidity available vs liquidity demands of product portfolio
MEDIUM RISK Mostly highly rated Mostly liquid Moderate % in equities Minimal speculation	**MEDIUM RISK** Relatively well matched asset / liabltiy portfolio Riskier assets matched to surplus Liabilities more protected from surender charges
LOW RISK Mostly highly rated Mostly liquid Moderate % in equities Minimal speculation	**LOW RISK** No upcoming debt maturities Strong cash / cash flow available Sticky liabilities less likely to surrender

Indicates average ME market

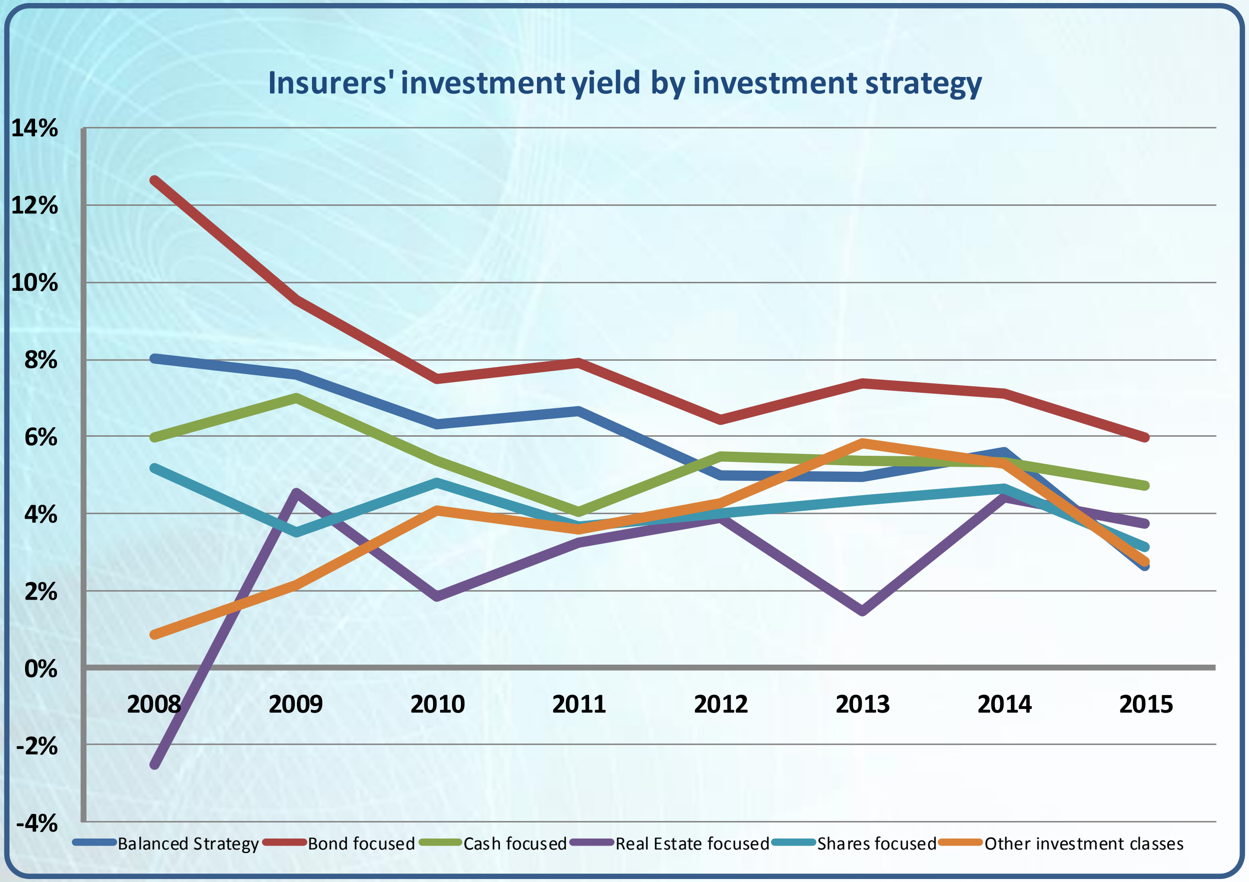
Insurers' investment strategies in MENA



Source: A.M. Best Statement File Global database

- MENA companies have shifted towards cash and away from equity focused investments
- Real estate and share based strategies are making a return
- Market overall seems to take less risk through investments than it did 10 years ago
- However, there are questionable valuation practices which may hide a larger exposure to some asset classes

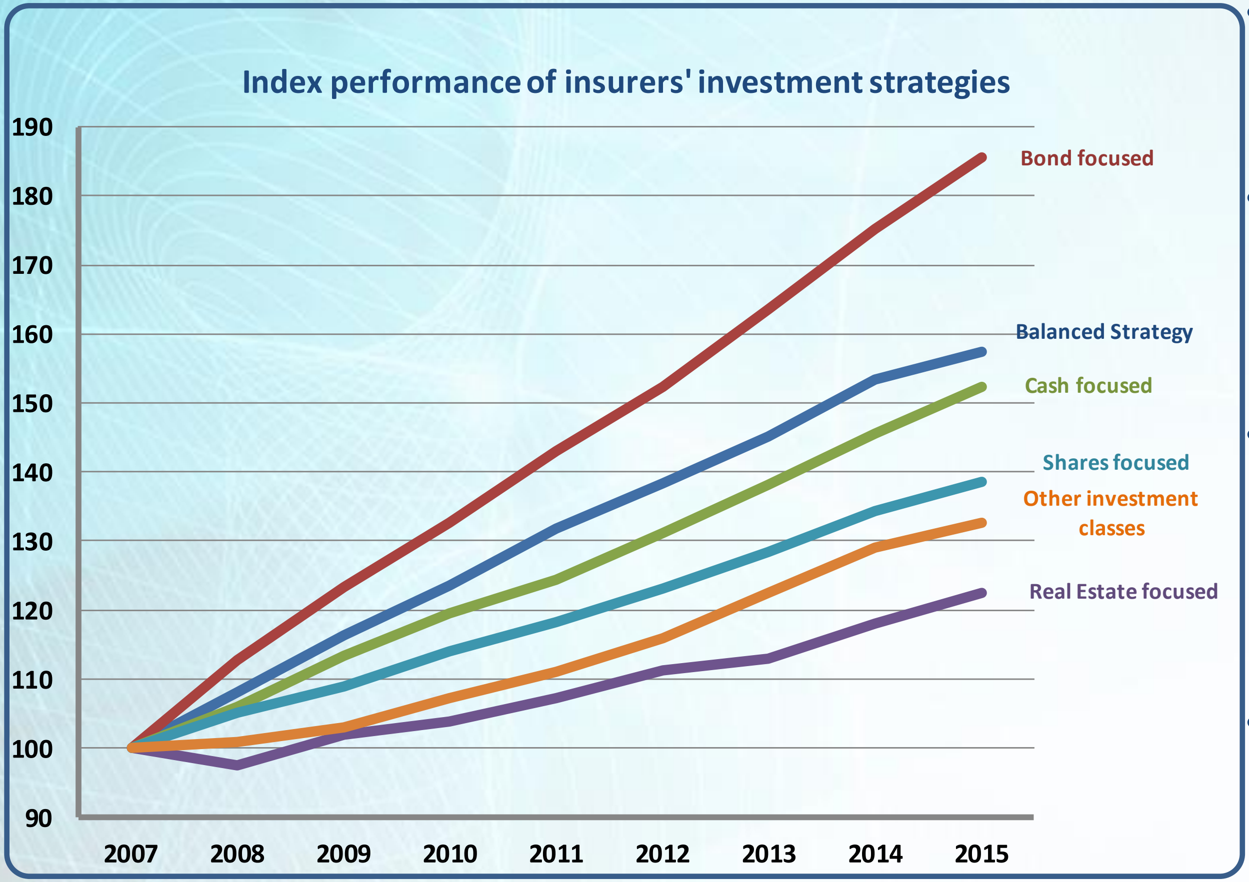
Investment strategies: risk but no reward?



- Companies with “bond focused” strategies have consistently the highest investment yields
- Companies focused on real estate experienced negative yields during financial crisis
- Not clear that increased risk is rewarded by results

Source: A.M. Best Statement File Global database

Are investment strategies based on facts or preferences?



Source: A.M. Best Statement File Global database

- Companies with bond focused strategies have the highest yields
- However, few countries in the region have bond markets able to cater for the insurers' needs
- Strategies focused on shares and real estate and "other" asset classes have the lowest yields
- Questionable valuation practices may have artificially inflated the yields from real estate assets

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Risk profile - reinsurance

Credit quality of reinsurance	Ceded leverage	Impact of reinsurance programme
HIGH RISK Unrated B rated or below No collateral	**HIGH RISK** Recoverables / PHS > 100%	**HIGH RISK** High retained exposure Parametric based No reinstates Exposure to frequency caps, corridors, APs
MEDIUM RISK B+, B++, A- Collateral on lower rated only	**MEDIUM RISK** 100% > Recov / PHS > 25%	**MEDIUM RISK** Moderate retained exposure
LOW RISK A or above Collateralised	**LOW RISK** Recoverables / PHS > 25%	**LOW RISK** Low retained exposure Indemnity based Multiple reinstates No caps, corridors, APs

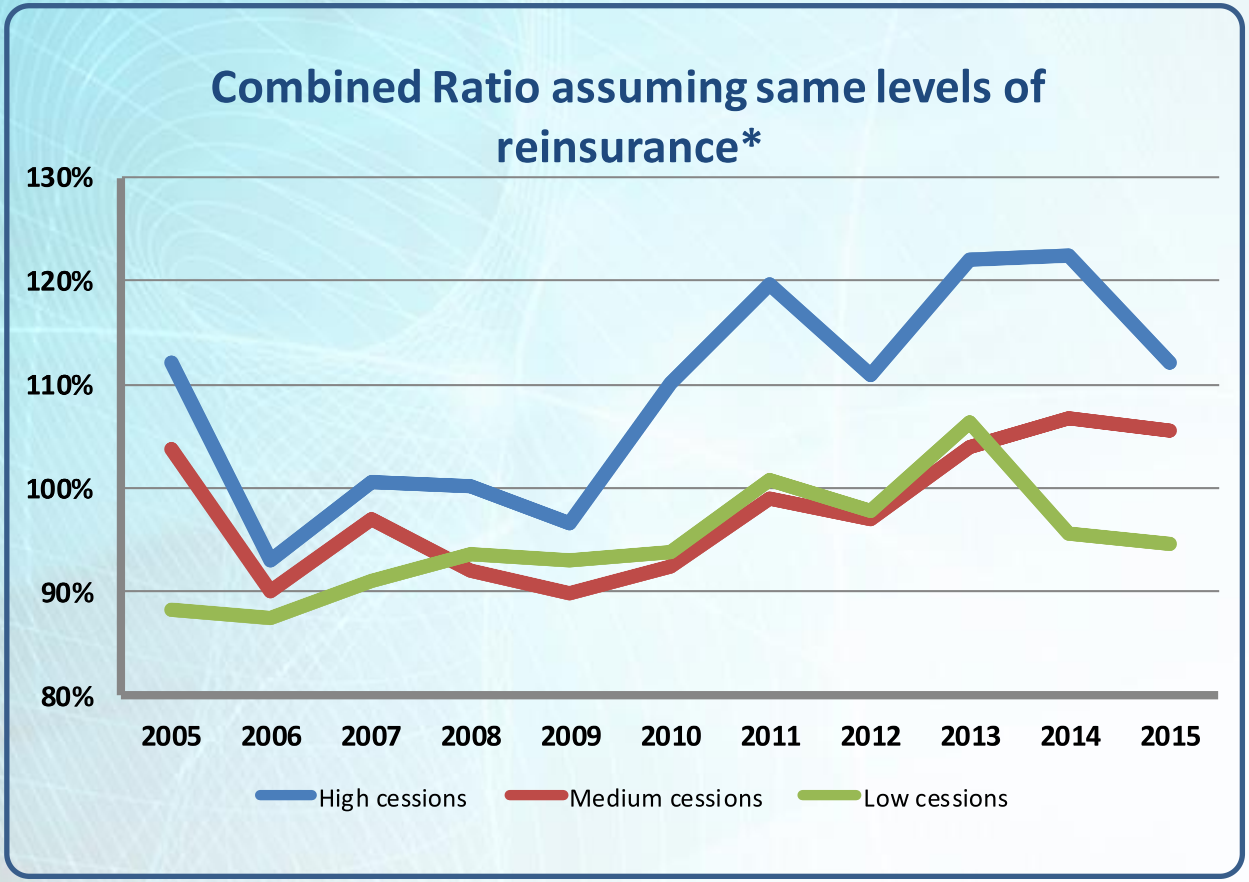
Indicates average ME market

Companies with low retention levels tend to have lower combined ratios. . .

Source: A.M. Best Statement File Global database

- There seems to be inverse relationship between retention and technical profitability
- Companies with high cession rates have low combined ratios and vice versa
- Companies with high cession ratios are the only ones which have combined ratio consistently below 100%
- Increasing trends in combined ratio for companies with high and medium cession levels may pose a threat for the future

. . . but in reality, they are the least profitable

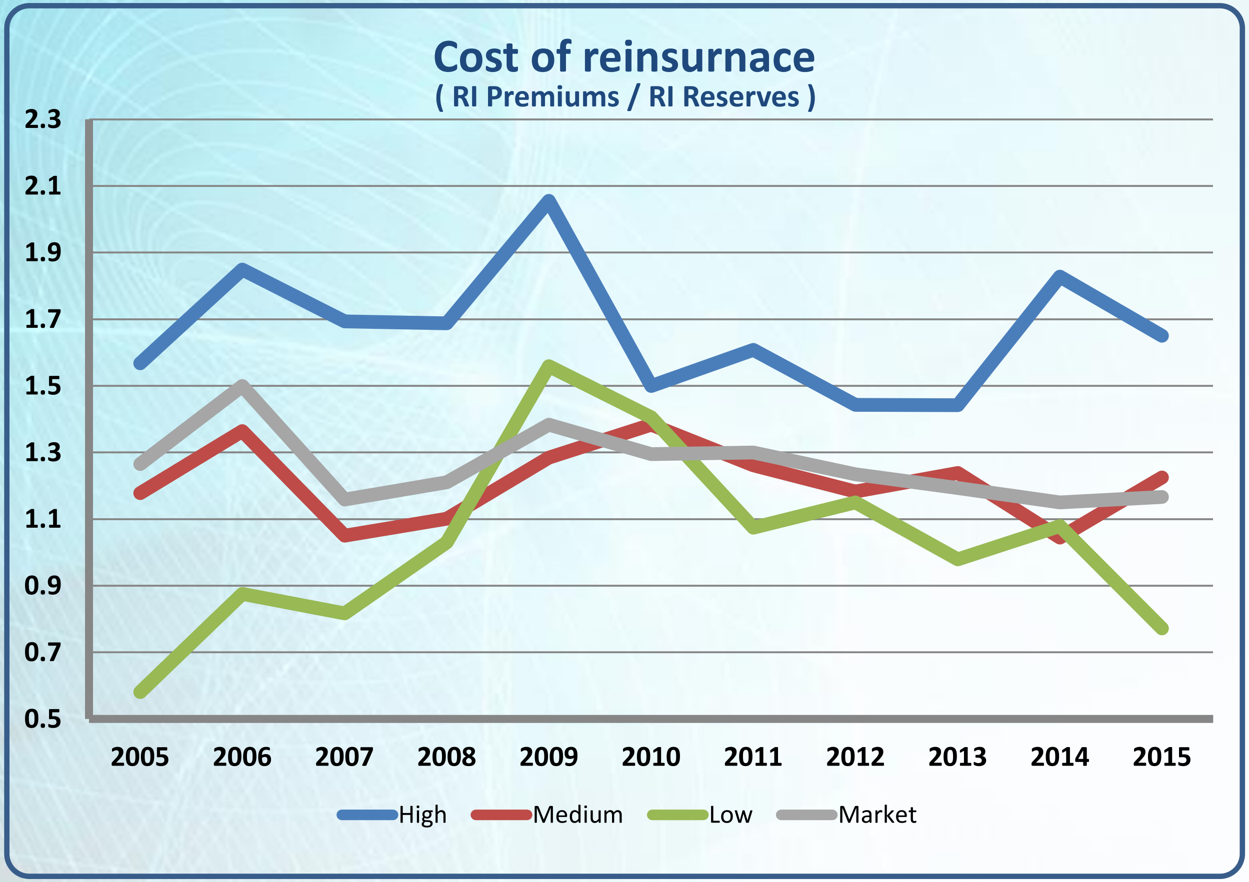


** Assuming all companies have low cession rates*

Source: A.M. Best Statement File Global database

- Companies with high cession rates are consistently unprofitable
- Profitability is achieved at the cost of reinsurer
- Higher claims ratios and high management expenses are the main drivers for increased combined ratios
- Companies with low reinsurance cessions tend to have the lowest overall combined ratios

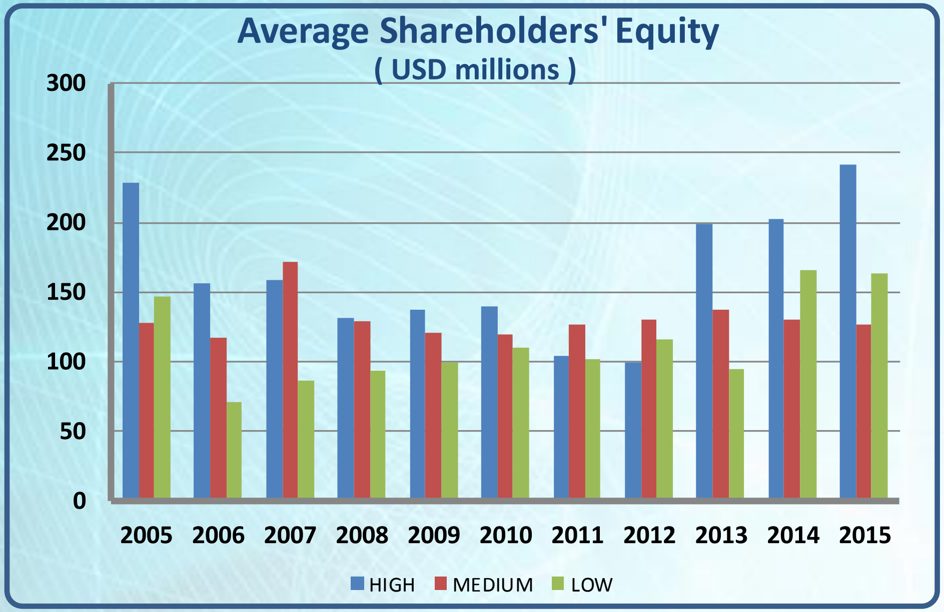
Not all companies benefit from soft reinsurance market

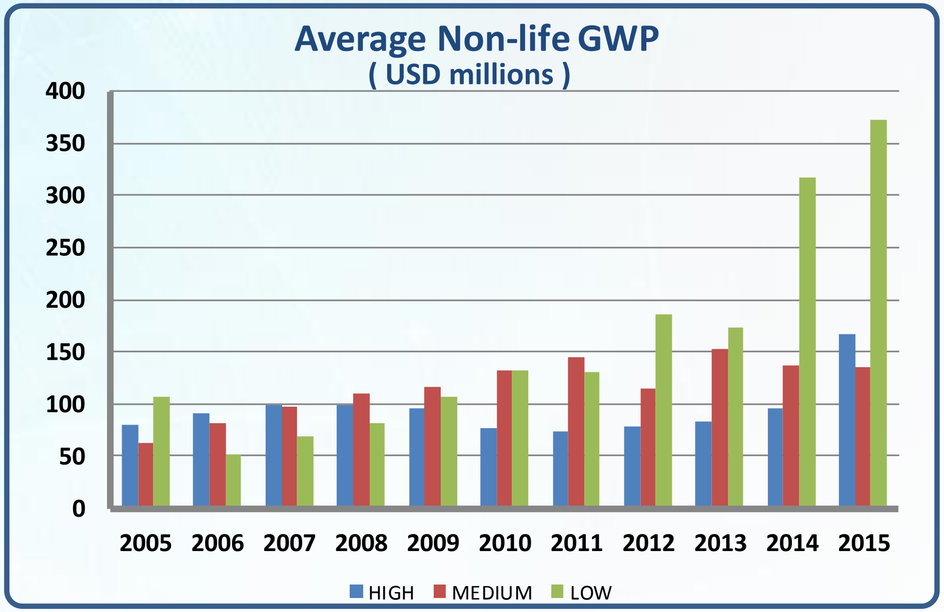


Source: A.M. Best Statement File Global database

- Indications that reinsurance rates have been declining for the last 6 years in the market
- Companies with moderate and low cession levels seem to have benefited the most
- Companies with low retention levels have seen the cost of reinsurance increase
- Is high reinsurance utilisation still a viable strategy?

High cession levels are not a result of necessity





Source: A.M. Best Statement File Global database

- Companies with high cession levels are among the highest capitalised in the market
- Companies with high cession levels write moderate levels of business
- High reinsurance cessions are not a result of scarce capital resources being under pressure

Correlation between investment and reinsurance strategies

INVESTMENT STRATEGY

REINSURANCE UTILISATION	Balanced strategy	Cash focused	Bond focused	Shares focused	Real estate focused	Other focused
High levels of reinsurance	26	123	20	64	13	28
Medium levels of reinsurance	87	417	142	135	61	67
Low levels of reinsurance	67	456	190	82	52	70

Counterparty risk: Low → High

Risk: Low → High

Source: A.M. Best Statement File Global database

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Conclusion

1. ERM is not a prerequisite for a rating
2. ERM is important for successfully running an insurance company
3. Companies with strong ERM are likely to have better performance and stronger capitalisation
4. These can in turn result in a higher rating