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Global Reinsurers' Complex Risk Profiles Demand Sophisticated Enterprise Risk Management

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ERM And Its Growing Role In Reinsurer Performance And Ratings

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Standard & Poor's Ratings Services has been conducting its enterprise risk management (ERM) assessments of insurers since the introduction of its ERM criteria in November 2005. Our ERM opinions on most of the rated reinsurance groups in reinsurance have been made public in those companies' individual analyses. This article compiles these opinions for the first time (see Table 1) and explains our aggregate findings, analyzed by the various components of ERM.

Table 1

| ERM Scorecard For Rated Global Reinsurers | | | |
|--|-------------------------------------|--------------------------------------|--------------------------------|
| Excellent | Strong | Adequate | Weak |
| Manulife Financial Corp. | ACE Tempest Re | Amlin Bermuda Ltd. | Caisse Centrale de Réassurance |
| PartnerRe | Arch Capital Group Ltd. | Allied World Assurance Co. | Odyssey Re |
| RenaissanceRe Holdings Ltd. | Aspen Insurance Holdings Ltd. | AXIS Capital Holdings Ltd. | |
| | Endurance Specialty Holdings Ltd. | Catlin Insurance Co. Ltd. | |
| | Hannover Re | Converium | |
| | General Re | Everest Re | |
| | Munich Re | Folksamerica Reinsurance Co. | |
| | National Indemnity Co. | Harbor Point Re Ltd. | |
| | Platinum Underwriters Holdings Ltd. | Lloyd's | |
| | Swiss Re | Max Capital Group Ltd. | |
| | | Montpelier Re Ltd. | |
| | | SCOR | |
| | | Sirius International Insurance Corp. | |
| | | Transatlantic Holdings Inc. | |

Charts 1 and 2 show how the global reinsurance market compares with the insurance market as a whole.

Chart 1

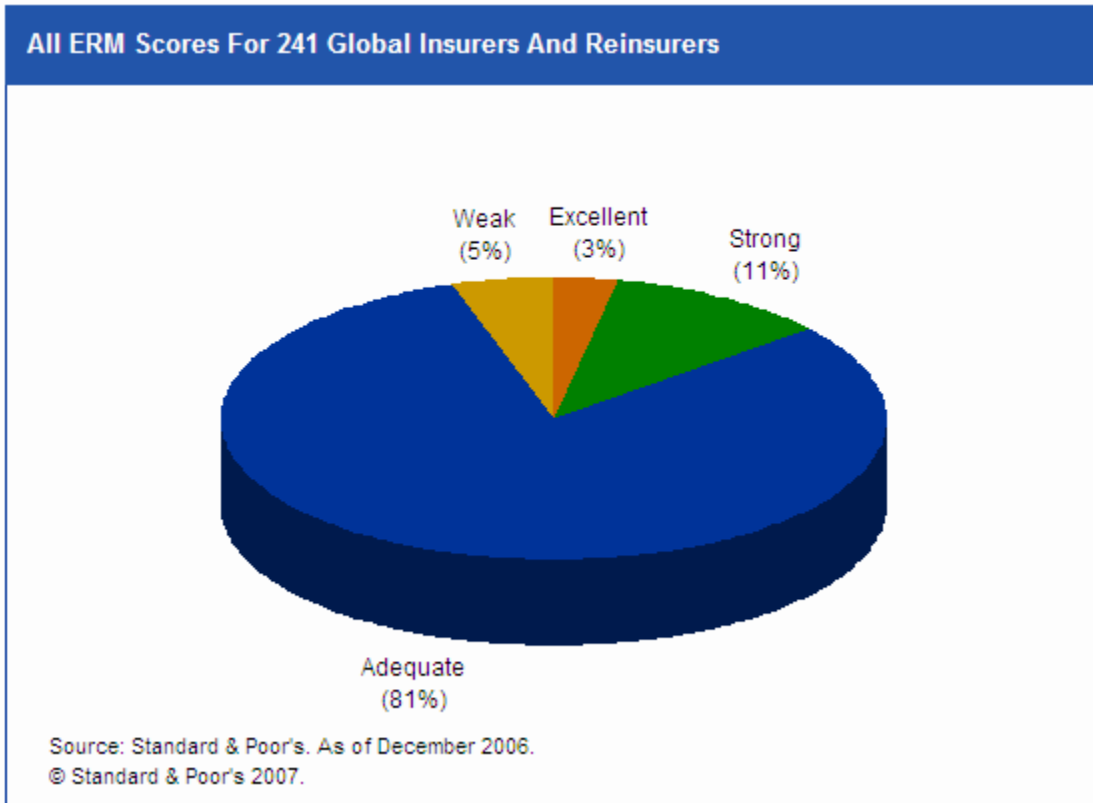


Chart 2

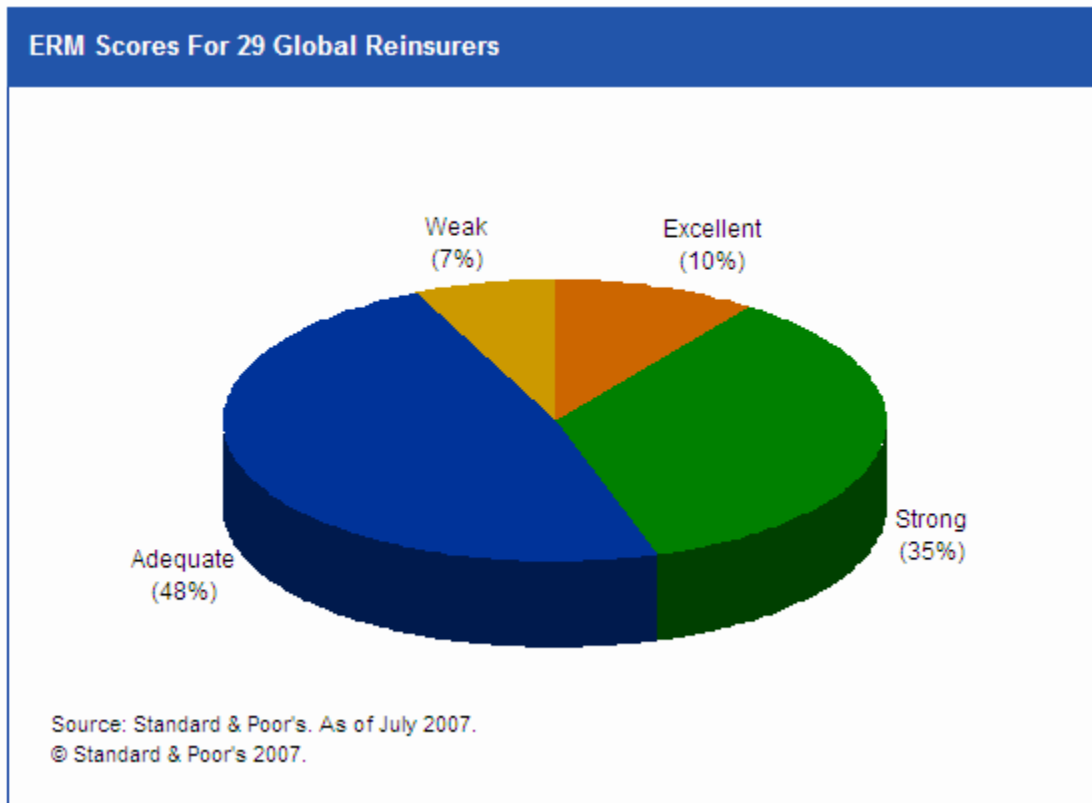


Table 2

Definitions Of Standard & Poor's ERM Classifications

| Classification | Definition |
|----------------|---|
| Excellent | Excellent ERM programs share all the criteria for programs considered strong but are more advanced in their development, implementation, and execution effectiveness. An excellent ERM insurer will have developed its process more fully over time, may have implemented it throughout a higher percentage of its group, or may be executing the process more effectively. |
| Strong | Strong ERM insurers have exceeded the adequate criteria for risk control and have a vision of their overall risk profile, an overall risk tolerance, a process for developing the risk limits from the overall risk tolerance that is tied to the risk-adjusted returns for the various alternatives, and a goal of optimizing risk-adjusted returns. In addition, strong programs have robust processes to identify and prepare for emerging risks. Standard & Poor's expects ERM to be a competitive advantage for these insurers over time. The process of selecting choices that have the best risk-adjusted returns should result in lower losses per unit of income over time, allowing these insurers to choose between offering lower prices, paying higher dividends, retaining higher capital, or obtaining capital at a lower net cost than competitors without the ERM advantage. |
| Adequate | Adequate insurer ERM programs have fully functioning risk control systems in place for all major risks. The risk management process is solid, classical, and silo-based, and most insurers fall into this category. However, these insurers often lack a clear vision of their overall risk profile and often lack overall risk tolerance. Risk limits for various risks have usually been set independently, and systems for each risk element usually function completely separately, without any significant coordination across silos of its risks. Adequate insurers also lack a robust process for identifying and preparing for emerging risks. Since neither a cross-risk view nor overall risk tolerance exists, no process to optimize risk-adjusted return is present either. Standard & Poor's does not expect these companies to experience any unusual losses outside of their separate risk tolerances unless a rapid, major change occurs in the environment related to one or more of their major risks. Insurers can also have adequate ERM if the insurer has developed a cross-risk view, and an overall risk tolerance uses risk-return considerations for its business decisions and has a process for envisioning the next important emerging risk but does not have fully developed controls. Adequate ERM should not be a negative factor in most insurer ratings. |
| Weak | Weak insurer ERM programs cannot consistently control all of an insurer's major risks. Control processes are incomplete for one or more major risks, and these insurers have limited ability to fully identify, measure, or manage major risk exposures. |

Source: Standard & Poor's.

ERM And Its Growing Role In Reinsurer Performance And Ratings

ERM evaluation continues to play an increasing role in Standard & Poor's analyses of the capabilities of reinsurers to manage the various risks to their balance sheets efficiently. The following are themes that underlie our global perspective on reinsurers' ERM:

- **ERM enhancement.** A significant number of firms currently viewed with adequate ERM are on track to migrate to the strong category in the near future. Likewise, some of the current strong ERM insurers are on track for excellent designations.
- **Modeling improvement.** Reinsurers continue to refine their insurance risk modeling proficiency related to catastrophe and noncatastrophe exposure management and pricing.
- **Economic capital (EC).** Reinsurers are increasingly relying on internal models for more effective capital allocation and to improve their understanding of risks inherent to their organization.
- **Cycle management.** ERM is expected to support improved cycle management as softening pricing, terms, and conditions continue for most lines of business. EC models are increasingly informing insurers' views of price adequacy.

ERM impact on ratings

ERM is emerging as one of the strongest indicators of an entity's ability to deliver an appropriate cross-cycle risk-adjusted return, which is expected to be a key driver for reinsurer ratings over the medium term.

With 241 insurers and reinsurers assessed through 2006, only 14% had strong or excellent ERM, while 81% of the industry was viewed as adequate. Half of those viewed as strong or excellent were reinsurers or multiline writers with significant reinsurance operations, which is evident in Charts 1 and 2. Some 60% of Bermudians that were assessed for ERM were either strong or excellent. These results suggest that reinsurers, and particularly the Bermudians, lead the overall industry in the sophistication and advancement of their ERM frameworks. However, several firms are undergoing enhancements to their ERM processes, particularly in strategic risk management. It is our expectation that many insurers and reinsurers currently viewed as adequate are on track to migrate to the strong category as these enhancements are fully implemented and seasoned. Global reinsurers, such as Swiss Re and Munich Re, have invested in ERM over an extended period, typically longer than their Bermudian peers. Given the diversity of their risks and their global reach, they have the greatest need to do so, and attaining the highest ERM designation is more challenging as a result. The Bermudians typically have a narrower risk profile and therefore the need to achieve high ERM designations is lower, but achieving higher designations is more straightforward.

Many reinsurers are developing or enhancing their insurance risk modeling capabilities, which should enhance their overall ERM framework. Despite the benign catastrophe experience and exceptional industry-wide returns in 2006, threats of earnings volatility largely related to extreme events remain for much of the reinsurance sector. We feel that sound capital and exposure management related to catastrophic events is crucial for most reinsurers. In our view, most firms have enhanced their risk-management capabilities in this area in the past 18 months, though the efficacy of these enhancements is unproven. These enhancements have taken many forms including a more critical evaluation of vendor model outputs, more clearly articulated catastrophe risk tolerance, enhanced emphasis on data quality, and general improvements in the underwriting process. That said, a small number of reinsurers are reluctant to embrace more sophisticated risk-management processes, beyond a traditional silo-based framework, which may create certain competitive disadvantages in the future for those firms. As an example, Standard & Poor's believes

that an entity's future level of access to the capital markets after a large event could be constrained if its losses exceed its stated risk tolerance and/or are disproportionately large relative to peers.

Economic capital modeling is becoming a more prominent tool to support the risk management process. This is particularly apparent with European and Bermudian reinsurers, where commercial and regulatory pressures (such as Solvency II) and growth in risk profile complexity will demand more sophisticated risk modeling capabilities. Incentives emerging under Solvency II to be regulated using internal models and in Standard & Poor's capital adequacy analysis (excellent and strong ERM insurers can expect to derive capital relief based on their internal models from 2008 onwards) will drive more reinsurers to adopt EC models.

Competitive pricing and broadening terms are apparent for casualty and specialty lines, though property catastrophe is not immune to softening cycle conditions. Standard & Poor's feels some reinsurers have sound ERM frameworks to better understand the timing and effects of the changing cycle. This will make them better prepared for market downturns and resulting capacity management. However, this will be closely scrutinized in the near term.

ERM has been a major factor for overall ratings for several reinsurers. Standard & Poor's expects this trend to continue. In the past six months, positive views on ERM were cited as contributing factors for favorable rating actions on Munich Re and Aspen Re, while weaknesses in ERM were cited as key considerations for negative rating actions on Everest Re.

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