

Strengthening Risk Management Capabilities in the Takaful Industry

**The rating process:
the importance of risk management**

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A.M. Best overview

- Established in 1899 in the US, pioneered the concept of financial strength ratings in 1906
- Only international rating agency focused on the insurance industry
- The world's leading provider of insurer Financial Strength Ratings (FSR) by company coverage
- Coverage of >3500 companies in >65 countries
- Specific takaful & new company formations rating methodology

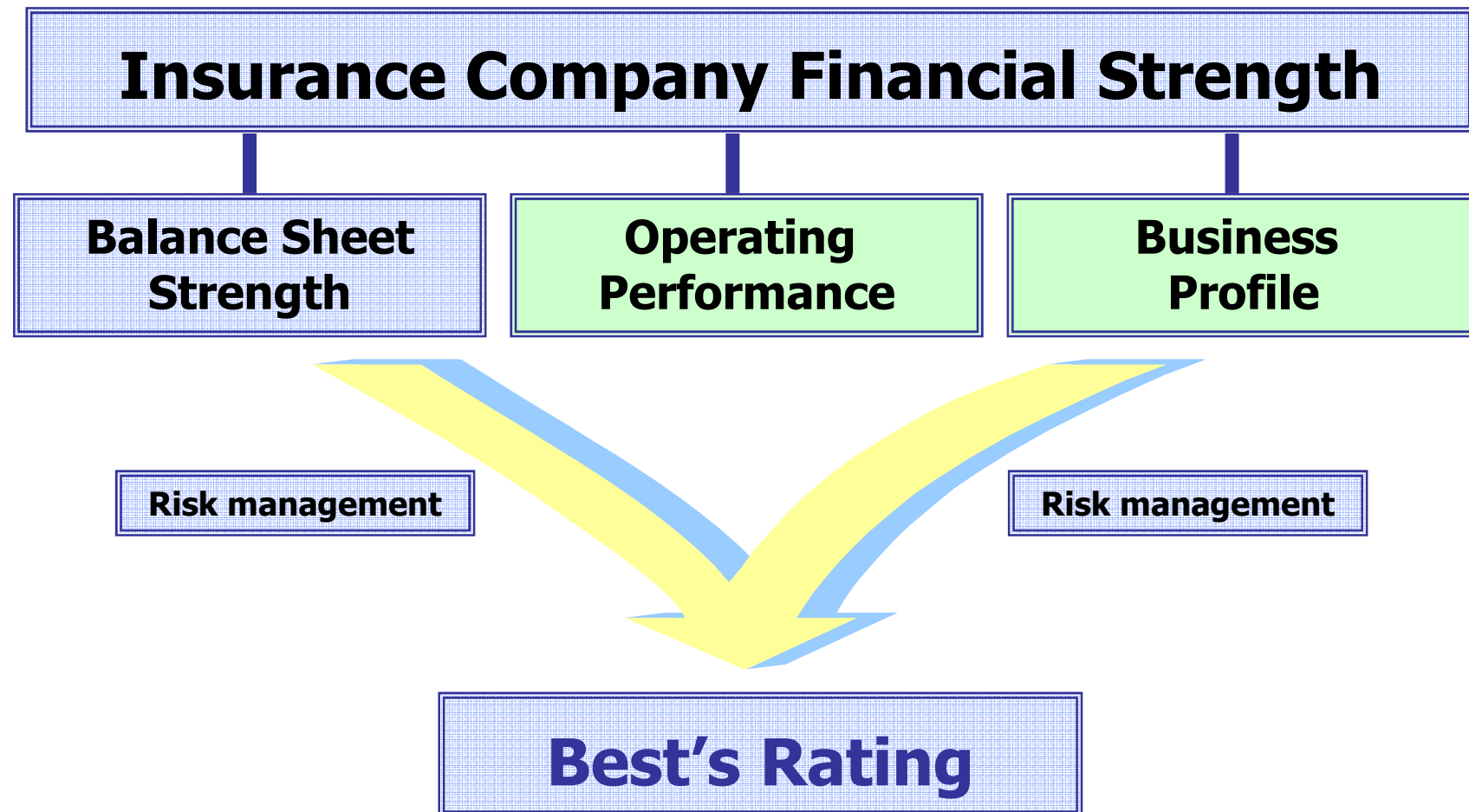
Seeking to play a leading role in the development of the international takaful market

Why do takaful companies choose to be rated?

- Facilitates market entry and development
- Demonstrates equivalence with conventional insurer security
- ‘Business critical’ requirement for most credit sensitive market segments e.g. reinsurance, large commercial business
- Can be perceived as a sign of ‘quality’ and operational excellence
- Can facilitate capital raising and reinsurance purchase
- Provides independent oversight supporting corporate governance & risk management processes
- Satisfies regulatory & financing requirements in certain jurisdictions

Internationally recognised independent view of financial strength

A.M. Best rating methodology – 'traditional' key rating components



 *Lead indicators of future balance sheet strength*

A.M. Best capital model - Best's Capital Adequacy Ratio (BCAR)

- Acts as a global 'capital adequacy' benchmarking tool
- Risk-based capital model capturing three broad risk categories
 - underwriting (and reserve adequacy)
 - investments
 - counterparty credit
- Capital charges determine Net Required Capital
- Policyholder surplus is subject to both positive and negative adjustments to give Total Adjusted Capital
- Best's Capital Adequacy Ratio (BCAR) is determined:

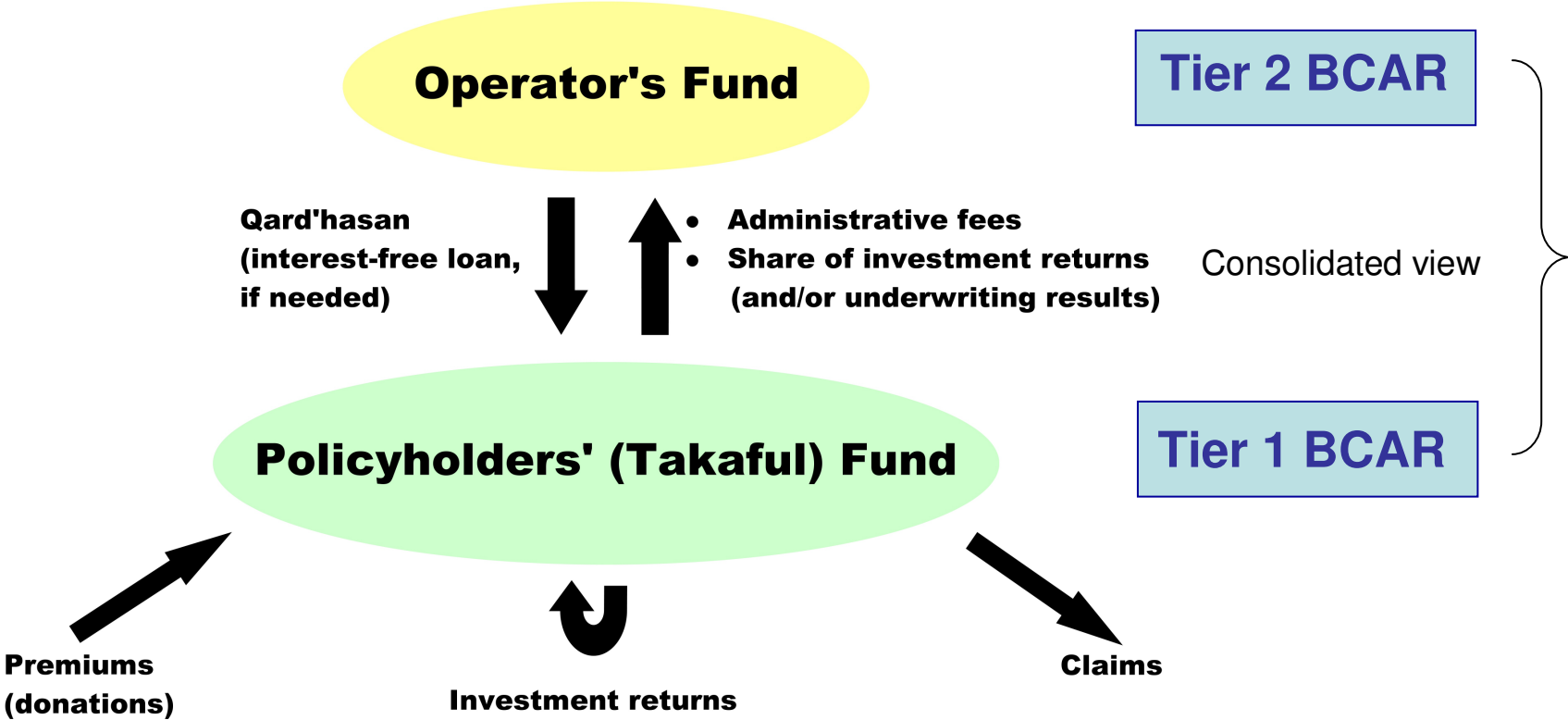
$$\frac{\text{Total Adjusted Capital}}{\text{Net Required Capital}}$$

Minimum capital ratios (BCAR) at various rating levels

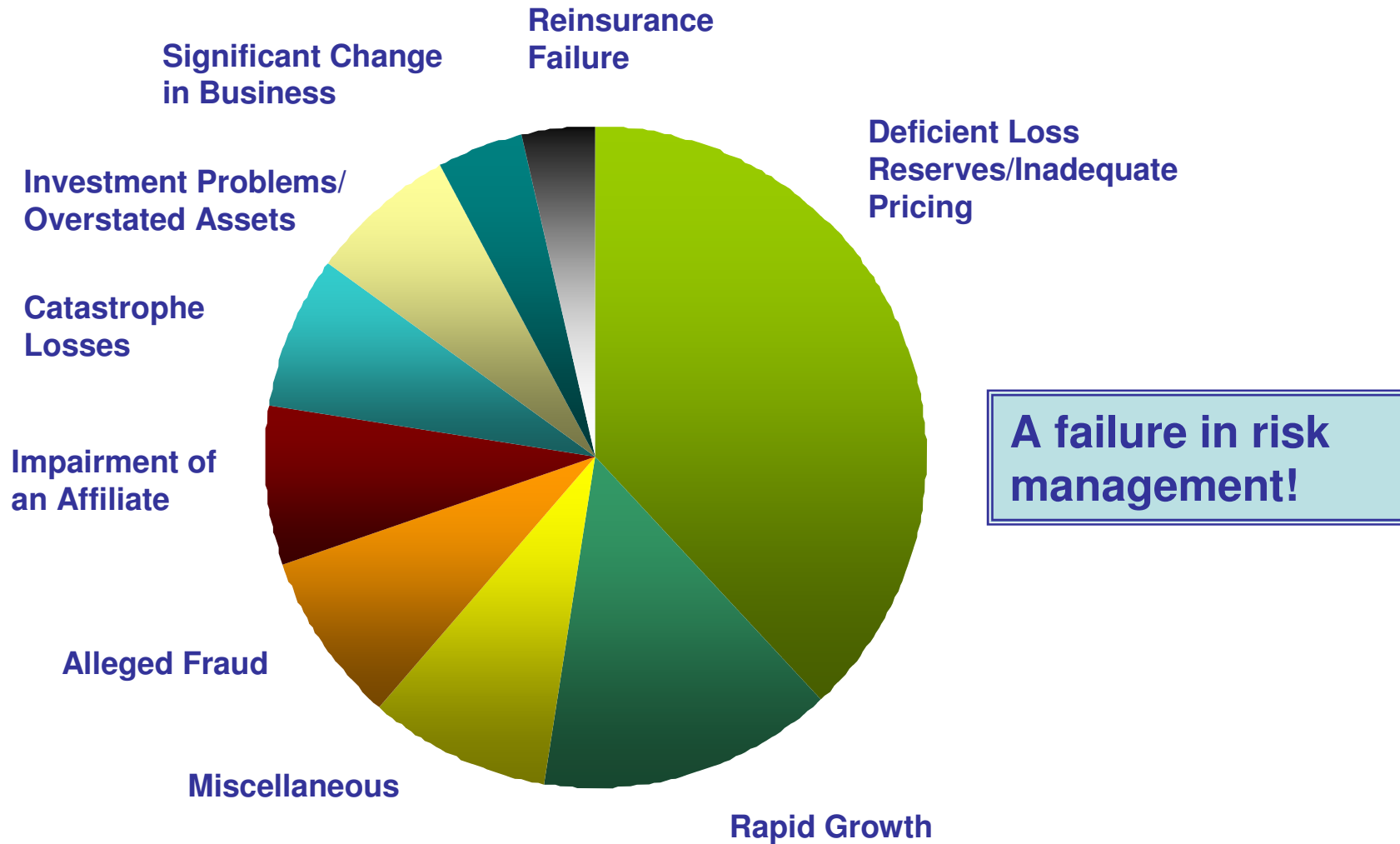
Secure		Vulnerable	
RATING	MINIMUM BCAR	RATING	MINIMUM BCAR
A++	175	B	90
A+	160	B-	80
A	145	C++	70
A-	130	C+	60
B++	115	C	50
B+	100	C-	40

- Significantly higher ratios are required for start-ups
- Capitalisation is only one element of the rating evaluation

Basic Takaful Model – Risk-adjusted capitalisation

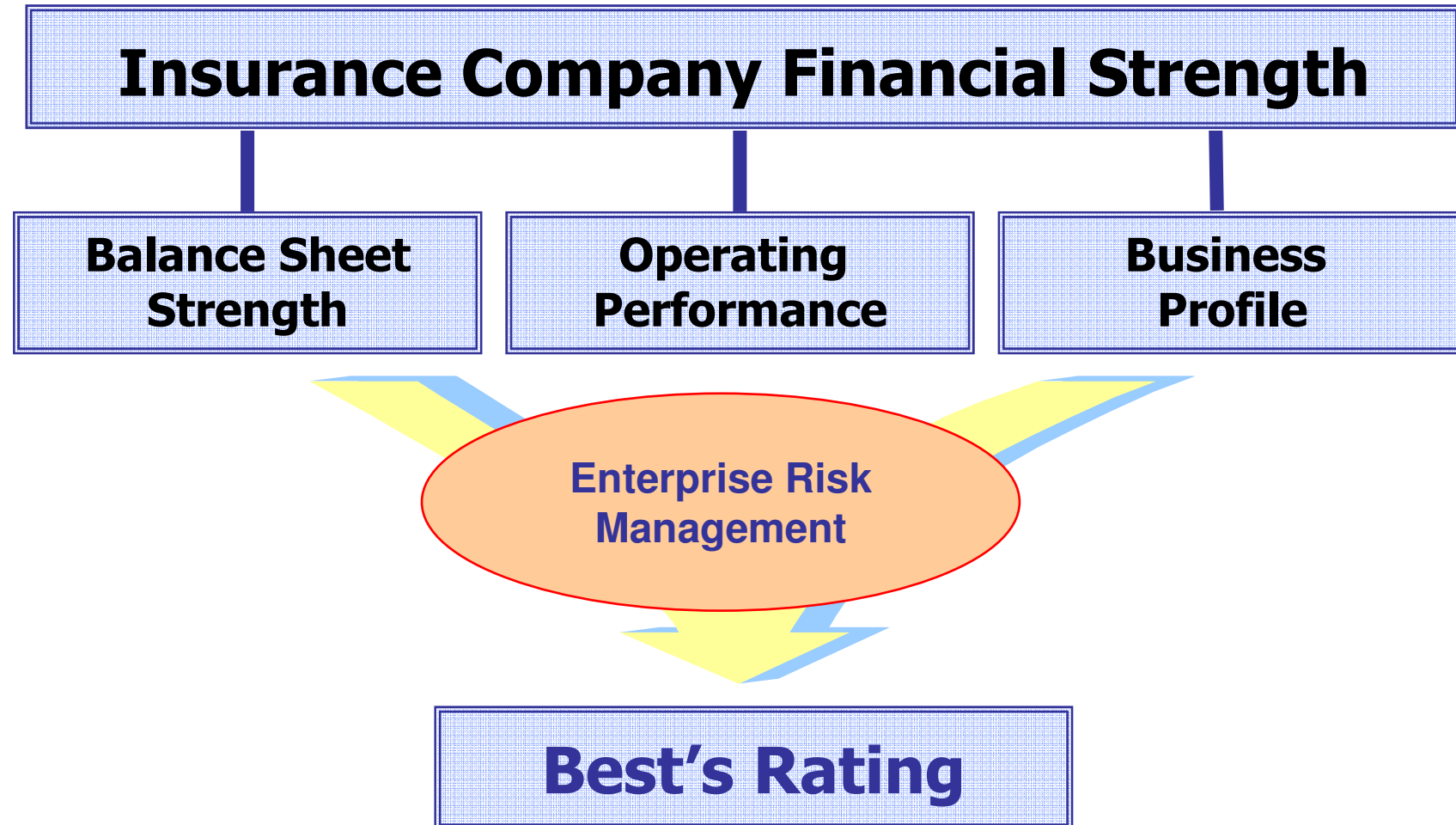


Why do insurance companies fail?



Source: U.S. Property/Casualty: 1969-2008 Impairment Review, April 6, 2009

A.M. Best rating methodology – 'enhanced' key rating components



What's new about Enterprise Risk Management (ERM) ?

- The development of an enterprise view of risk on a more holistic basis
- Builds on traditional risk management but considers correlations and interdependencies across the entire organisation;
 - credit risk
 - market risk
 - underwriting
 - operational
 - strategic
- Risk management is the common thread that links **balance sheet strength**, **operating performance** and **business profile** in the rating process
- ERM is incorporated into the rating analysis, but no separate rating evaluation is published
- Credit for companies implementing ERM will be recognised over time, i.e. a lower capital requirement relative to the BCAR guideline for a given rating level

How does AMB view Enterprise Risk Management?

- ERM fundamentals can be found in a company's...
 - strategic decision making process
 - financial management and control practices
 - daily operating procedures
- Lessons learnt from the recent financial crisis
 - ERM matters...more than ever
 - risk management fundamentals matter
 - credit analysis and sound underwriting
 - management experience and discipline
 - low probability 'tail' events do happen!

Risk management practices need to be proportionate to the organisation's risk profile (e.g. size, complexity, volatility)

Risk Management and BCAR – Best’s revised approach

A.M. Best Requirements:

Superior traditional risk management fundamentals
Superior capital management and financial flexibility
Strong ERM characteristics
Strong Economic Capital modeling capabilities

Weak Risk Management

Strong Risk Management

BCAR Guideline

BCAR

What's new...

LOW

HIGH

EXPOSURE TO EARNINGS and CAPITAL VOLATILITY

Enterprise Risk Management – Key topics & meeting agenda items (1)

- **ERM framework and culture**
 - board and senior management involvement
 - establishment and communication of risk management objectives
 - risk tolerance and key risk metrics
 - roles, responsibilities and oversight
 - strategic decision making
- **Risk identification and management**
 - traditional risk management (underwriting, credit and market/liquidity)
 - exception reporting – performance vs. key risk metrics (by functional area and/or risk type)
 - action plans for exception items
 - operational risk and strategic risk
 - emerging risk issues

Enterprise Risk Management – Key topics & meeting agenda items (2)

- **Risk measurement and capital modelling**
 - management reporting – performance vs. risk tolerance (corporate-wide, by line of business, by risk type)
 - risk correlation
 - tools (Economic Capital [EC] or other) used to determine required capital and capital allocation
 - disclosure of EC results; internal, rating agency, external
 - data integrity; completeness and accuracy of EC inputs
 - independent review of modeling process
- **Management’s perspectives on key risks**
 - top 5 risk exposures and critical success factors to managing these exposures
 - lessons learned through ERM development process
 - next steps in ERM development

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