AM BEST SINCE 1899 ®

BEST'S COMMENTARY

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Rising Economic Risks Highlight Importance of Enterprise Risk Management

ERM frameworks need to be dynamic in today's rising environment

Principal Takeaways

- The abrupt escalation of economic risks underscores the importance of enterprise risk management (ERM).
- Many insurers lack robust stress testing and reverse stress testing processes; strengthening these frameworks can further enhance understanding and management of risks
- The ERM framework of nearly 90% of our global rated population has been assessed as Appropriate. However, ERM processes are not static and need to evolve along with an insurer's risk profile.

Abrupt Escalation of Economic Risks

For the duration of the COVID-19 pandemic, insurers adopted a wait-and-see approach, as their actions were dictated for the most part by the spread of the virus, government-mandated shutdowns of businesses, and people's preference to isolate and to social-distance. The government-mandated shutdowns were accompanied by monetary easing (low interest rates) and fiscal policy actions (free loans, tax breaks) to alleviate the economic stress of citizens and commerce due to the mandates.

Record levels of quantitative easing caused inflationary pressures to increase rapidly, which were exacerbated by supply chain shortages and geo-political turmoil owing to Russia's invasion of Ukraine. To control the rapid rise in inflation, the Federal Reserve started raising interest rates to tame inflation. Insurers had to contend with a volatile equity market and widening credit spreads (indicative of growing credit risk).

Growing Insurance Risks ...

The frequency and severity of weather events in the recent past have deteriorated the results of P/C insurers and led to a record number of insolvencies of concentrated regional players in Florida, because their relatively smaller capital bases could not recover from the losses due to hurricane Ian. Reinsurance, which is such an essential component of risk management for these smaller insurers, became unaffordable, as reinsurers pulled back capacity and tightened pricing.

Social inflation—the rise in loss costs owing to changes in societal attitudes and preferences—has become a significant issue for insurers. As society becomes more litigious and see corporations as less trustworthy, attitudes towards corporations have become more cynical and the punitive damages levied on corporations on cases involving injury (perceived or physical) have escalated. These unanticipated claims costs are estimated to be in the tens of billions of dollars. Given the growth of trends such as litigation funding, social inflation is a key risk for the property/casualty industry.

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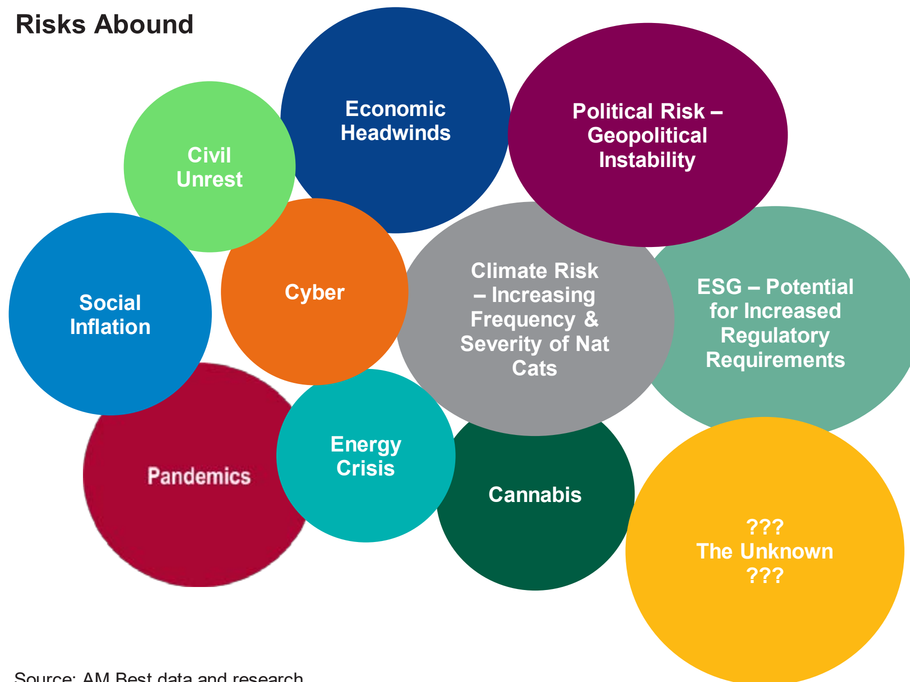
Exhibit 1
Risks Abound



Source: AM Best data and research

Cyber is becoming a better-managed risk but we ha ve yet to witness a true cyber catastrophe, given the significant protection gap. Bad actors are becoming increasingly sophisticated using social engineering and shrewd phishing tactics and exploiting GPTs (generative pre-trained transformers) to inject malware and hold businesses and insurers to ransom.

... Underscore the Importance of Enterprise Risk Management

Given the plethora of risks (**Exhibit 1**) insurers are exposed to, the impact of ERM cannot be overstated. ERM allows organizations to identify and quantify their risks, set risk tolerances based on their overall corporate objectives, and take the necessary actions to manage risk in light of those objectives.

AM Best's ERM analysis is based on an understanding of an insurer's risk management framework and risk management capability relative to its risk profile. AM Best views management of an organization's exposure to potential earnings and capital volatility, as well as the maximization of value to the organization's various stakeholders, as the fundamental objectives of an ERM program. Sound ERM practices and effective execution of strategy within stated risk tolerances will build and preserve balance sheet strength and bolster performance over the long term.

Regardless of evolving or emerging risks—rising inflation and interest rates, the lingering impact of COVID-19, growing cyber threats, as well as social inflation—dynamic ERM strategies have for the most part risen to the occasion. The ERM frameworks of nearly 90% of AM Best's global rated population have been assessed as Appropriate (**Exhibit 2**). The components of ERM programs we evaluate include governance/risk culture, risk management and controls, risk identification/reporting, stress testing and non-modeled risks, and risk appetite/tolerance. A lack of or weak ERM framework can contribute to failures that can occur when insurers do not understand their key risks, which can lead to a failure to maintain adequate protection against stresses and shocks.

Stress Testing—and Reverse Stress Testing—Becoming More Critical

Stress testing allows management teams to view the impacts of severe but plausible scenarios on insurers' balance sheets and operating results. Stochastic modeling generates a distribution of

Example of Risk Management Failure #1– Silicon Valley Bank

SVB became a casualty of rising interest rates and insufficient risk management. As interest rates rose and monetary conditions tightened, venture capital firms found accessing funding difficult and resorted to withdrawing their cash deposits from the bank. The bank was forced to sell longer-term assets at a loss, which led to a run on the bank. SVB's failure provides lessons pertaining to both liquidity and asset-liability management risk.

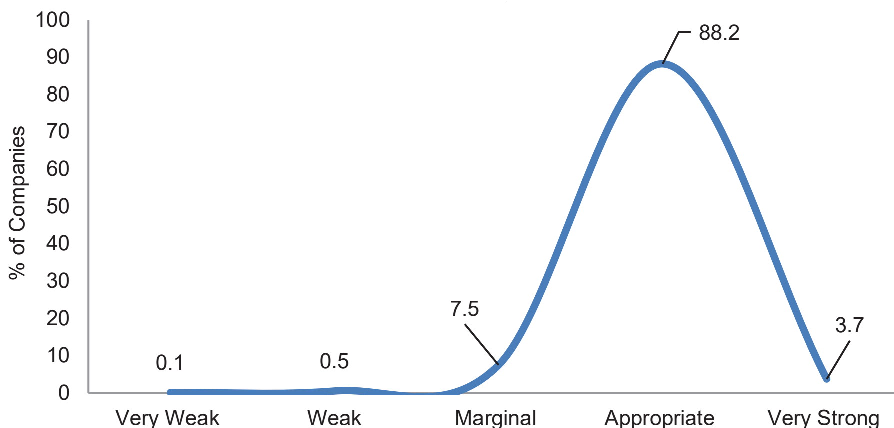
results while stress tests allow management to examine events that management, regulators, and other stakeholders such as ratings agencies are concerned about given a firm's risk profile. For example, an insurer with exposure to catastrophes may examine the results of a large catastrophe in its vulnerable coverage area that is followed by an increase in reinsurance rates. Insurers with long-term liabilities (such as annuity providers and long-term care insurers) can use economic scenarios such as rising interest rates and equity market performance to identify their impact on cash flows and capital.

Stress testing is not limited to underwriting, but also considers investment and geopolitics, among many other factors; it also aids insurers in developing contingency plans—for example, if an event falls outside of expectations, a company should have mechanisms to restore capital to an appropriate level in a timely manner. Stress testing is important for all companies, regardless of size. It can help management evaluate a firm's modeling process, assumptions, and data, and provide valuable insights into the amount of risk an insurer can assume and how it can manage the assumed risk. Insurers may also consider non-modeled scenarios in addition to modeled output to ensure that they are not overexposed to unforeseen events.

Insurers have room to improve their stress testing capabilities, as 30% of AM Best's global rated population have stress testing assessments in the bottom three categories: Evolving, Nascent, or Unrecognizable. These companies often lack the capability to manage concentration risk effectively— in recent years, companies' operating results have deteriorated due mainly to weather-related events and an increase in fire losses. Additionally, few companies (10.5%) have been assessed as having an embedded stress testing program (**Exhibit 3**).

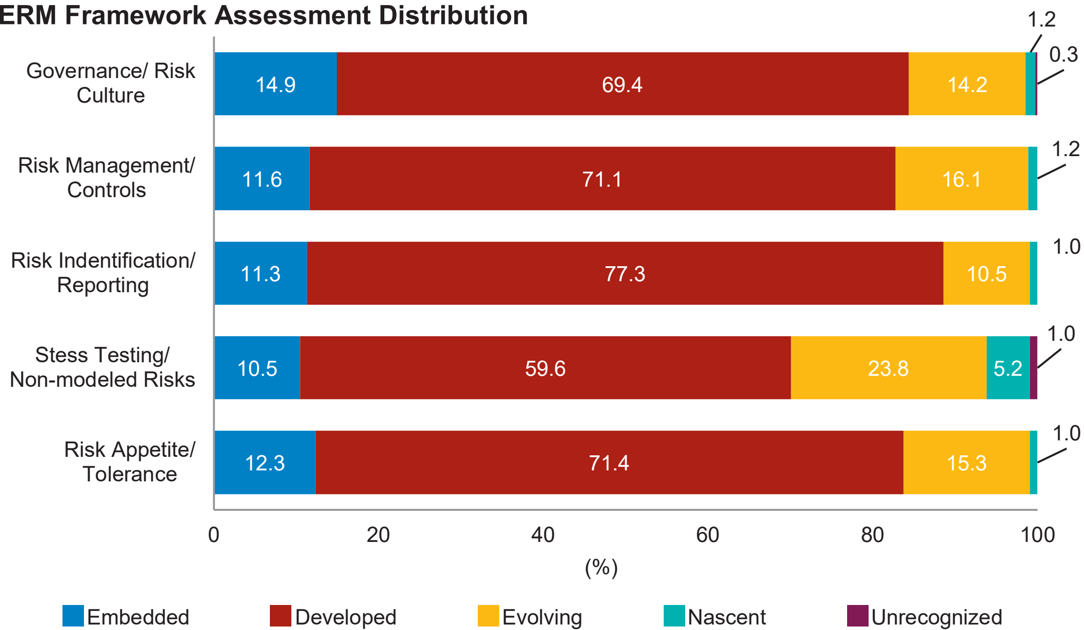
Reverse stress testing examines scenarios under which a company fails and understanding how far in the tail the scenario events are. Such testing starts with an insurer's financial condition—for example, if risk tolerance levels are breached, ratings are downgraded, or capital deteriorates to

Exhibit 2
ERM Assessment Distribution – Global, YE 2022



Source: AM Best data and research

Exhibit 3
ERM Framework Assessment Distribution



Source: AM Best data and research

levels regulators consider inadequate. It also involves examining the circumstances that could cause these conditions. Reverse stress testing could also involve examining an insurer's economic capital model and the scenarios where these tolerances are breached. The capital model could reveal correlations in the event of stress—for example, catastrophe losses at the same time as a liquidity crunch caused by the company's investment profile.

Exhibit 4
ERM Framework Risk Assessment Scoring

	2020	2021	2022
Product/ Underwriting	5.6	5.6	5.8
Reserving	5.3	5.2	5.5
Concentration	6.6	6.3	6.5
Reinsurance	5.2	5.0	5.2
Liquidity/Capital Management	5.8	5.8	6.0
Investments	5.1	5.1	5.4
Legal/ Regulatory	5.1	5.1	5.4
Operational	5.3	5.4	5.6

Green denotes a decline in risk. Red denotes an increase in risk.
Source: AM Best data and research

ERM Frameworks Need To Be Dynamic

As part of its risk impact analysis, AM Best scores a variety of risks for each company. Risks assessed include product/underwriting, reserving, concentration, reinsurance, liquidity/capital management, investments, legal/regulatory, and operational. The year 2022 brought uncertainty and change in the economic and operating environment, and we saw worsening risk profiles across each category compared to 2021 (**Exhibit 4**). Concentration and liquidity/capital management were the biggest risks; reserving, investments, and legal/regulatory risks grew the most from 2021.

Favorable practices include using risk tracking indicators to serve as early warning signs for worse-than-anticipated events. Strong risk management programs will help insurers tackle future uncertainties. Risk policy and risk standards have improved, as have risk identification and detailed risk appetite and tolerance statements. Key risk indicators are broad, and insurers have focused on timely reporting of these factors to stakeholders. Rate increases and tactical investments should provide opportunities to extend the duration cycle, with pricing discipline providing a clear advantage in most circumstances. The talent in risk management teams has grown over the last 12 to 24 months, as the need for a dedicated team of ERM professionals with specific experience will be necessary to compete effectively.

Example of Risk Management Failure #2 – FTX

In December 2022, the importance of corporate governance was highlighted by the failure of FTX, a Bahamas-based cryptocurrency exchange, in which authority was in the hands of one individual, with no board for oversight. Management teams with both strength and depth of experience are essential for insurance companies for the appropriate execution of strategy. A lack of accountability of executives or too much power held by a single individual leads to poor decision-making. FTX's failure also highlights the importance of high-quality, independent financial reporting for (re)insurers.

ERM also incorporates important aspects of cyber security threats that emerged during the pandemic. Many have established enhanced cyber security controls and monitoring. Ineffective risk management practices and a lack of employee training could become problematic in the event of more severe cyber attacks—threat incident response plans should always be in place. Additional internal training and awareness are extremely important to protect against phishing attempts or breaches. And, given the rising cost of cyber security coverage relative to the benefits provided, many insurers remain vulnerable to cyber attacks.

A robust ERM program will help insurers manage volatility by managing risks. Insurers with well-developed ERM programs will also be better equipped to identify and react to emerging risks.

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