

Enterprise Risk Management (ERM) for the (Re)Takaful Industry

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Introduction – The Quest for Capital

How many companies

- Cared about capital 15 years ago?
- Allocated capital 15 years ago?
- Don't allocate capital today?
- Have one integrated capital and risk management model?
- Allocate results and value today?
- Pay their management based on value created?

And yet Capital is Everywhere

Capital and it's Constituents

- **Investors:** want risk adjusted return on capital
- **Regulators:** move towards risk based solvency capital regimes
- **Rating agencies:** capital adequacy
- IFRS / US GAAP / Local GAAP
- Research analysts

Each have historically differing views which are now starting to converge

Capital and Risk

Approximately 650 impairments*
over 38 year period 1969-2006

Cause (1969-2006)	Pct Total
Deficient Loss Reserves / pricing	37.6%
Rapid Growth	15.7%
Alleged Fraud	8.1%
Catastrophe Losses	7.7%
Impairment of Affiliate	7.2%
Overstated Assets	6.9%
Significant Change	4.4%
Reinsurance Failure	3.3%
Miscellaneous	9.0%

Source: A. M. Best Impairment Study, 2007

* A. M. Best defines impairment as restrictive regulatory action

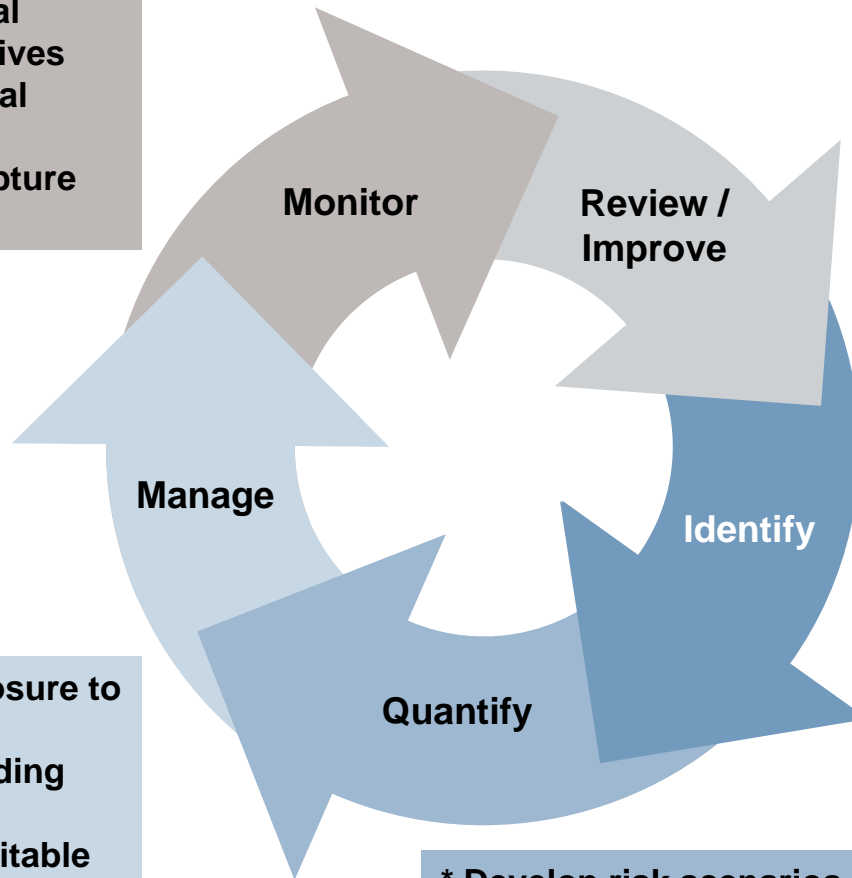
- Insurance related risks are driver of overall impairments but there is a strong correlation between insurance and operational risks
- Operational risks are significant
- Asset risk of secondary importance but now becoming more important due to fair value accounting
- Impairment frequency higher for smaller companies than larger companies

What is Enterprise Risk Management?

- ERM is the **process** by which companies identify, **measure, manage,** and **disclose all key risks** to increase **value** to **primary stakeholders** while satisfying other stakeholders
- ERM attempts to mitigate capital erosion by aligning the risk profile of the company to its strategic decisions
- **ERM is not** the next step in the evolution of risk management
- **ERM is** the next step in the evolution of business management

Overview of Aon's ERM Process

- * Integrate into internal reporting and incentives
- * Integrate into external communications
- * Risk database to capture experience



- * Current state assessment of ERM programme
- * Future visioning and gap analysis
- * Prioritise / develop plan to improve (Adopt framework and establish risk governance)

- * Internal qualitative surveys and interviews
- * Benchmarking
- * External expertise
- * Prioritise key risks

- * Manage overall exposure to risk appetite
- * Mitigate risks exceeding exposure limits
- * Exploit risks with suitable expected rewards

- * Develop risk scenarios
- * Quantify individual risks / scenarios
- * Quantify enterprise risk exposure
- * Determine risk appetite

Our ERM Capabilities

ERM

Capital Models

- Building risk based capital models
- Stochastic and deterministic approaches bespoke for your business
- Validating or enhancing your model

Controls & risk management

- Operational risk mitigation
- Developing corporate governance and internal control frameworks
- Internal audit
- Evaluating your existing structure
- Reinsurance and capital solutions

Culture

- Helping you achieve buy in from the business
- Training
- Aligning stakeholder interests

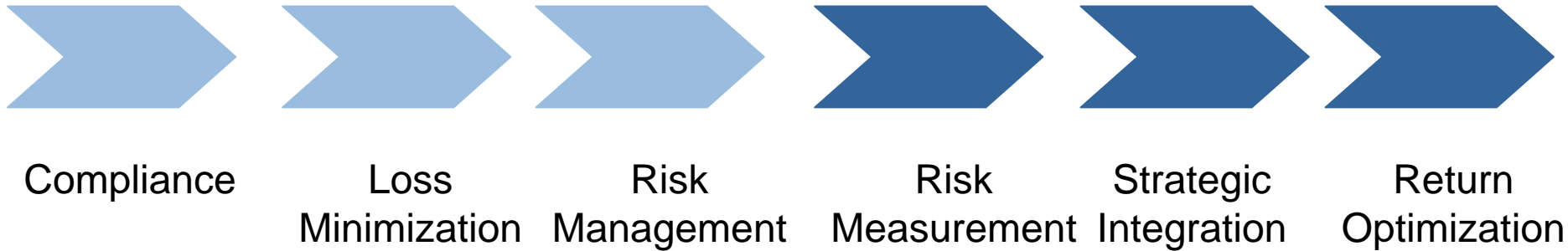
Rating Agencies and ERM

- ERM has been embraced by rating agencies
 - S&P (11/2005), A.M. Best (Spring 2006), Fitch (PRISM model, 2007)
- Risk Management is paramount to an insurer's long-term success
- Want to understand how risks are measured, monitored and managed
 - Strong risk-aware culture
 - Risk identification
 - Process for measuring, monitoring and managing
 - Strategic risk management
- Appropriate level of ERM is a function of the size and complexity of company

S&P European ERM Study

- S&P recently released the results from their first full year of ERM reviews
- Overall 86% of European (re)insurers have « adequate » ERM
 - 8% Strong
 - 4% Excellent
 - 2% Weak
- Companies are not yet benefiting from ERM and Strategic Risk Management
 - **Risk control**: strong but in silos with no focus on correlations of risks
 - **Emerging risk management**: weak and not addressed consistently
 - **Risk models**: weak, but improving
 - Many companies are currently investing heavily to improve their modelling capabilities in advance of Solvency II
 - Most companies do not pass the « use » test, which means they have not integrated the tools into their strategic decision making processes yet

Evolution of ERM



- Risk control and balance sheet protection were industry standard in past 5-10 years
- In next 5-10 years standard will be risk/return optimization and value creation
- The evolution also has a direct link with the strategy of the company

Benefits of ERM

- Clearly defined corporate risk appetite signals a well-run company
 - Strong risk management and brand are rewarded by investors
 - Better informed management decisions considering all key risks adds transparency to decision making process
- Promotion of risk awareness across the entire organisation
- Framework for dealing with regulators
 - Solvency II and Basel II, FSA in UK
- Rating agency expectations and capital requirements
 - Poor ERM capabilities result in downwards rating pressure
 - Good ERM capabilities result in upwards rating momentum
- Aligns stakeholder interests – investors / regulator / rating agency

Importance for (Re)Takaful Industry

- ERM will help with the strategic and operational challenges faced by (Re)Takaful operators
 - ERM will become a permanent fixture due to the changing risk landscape
 - event driven risks and correlation of risk
 - stakeholder needs
 - accounting, regulatory, legislative, corporate governance initiatives
 - ERM can leverage the significant investment required to compete with conventional insurance
 - ERM important for growing companies as it minimises the need to incur massive overheads associated with more manual methods of risk containment
 - Rating agencies may ultimately give credit to ERM models if they are robust and the underlying risk management framework is sound
- ERM protects policy holder interests and is consistent with sharia'h compliance e.g. reputational risks

Thank you.

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