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STANDARD & POOR'S PROPOSES NEW ERM LEVEL III REVIEW, SEEKS COMMENTS

In May, Standard & Poor's (S&P) released a proposal describing its intention to expand its review of insurers' Enterprise Risk Management (ERM) programs by introducing a new "ERM Level III" analysis. This new level will focus on the Economic Capital Models (ECMs) supporting ERM, and will be applied to all rated insurers once finalized.

From the proposal:

"Our proposed criteria describe those parts of an insurer's ECM we would typically analyze in an ERM level III review. We structured the proposed criteria around two sets of modules. The first set of modules analyzes "indistinct" risks such as the approaches an insurer uses to model total targeted resources, to value liabilities and assets, to model potential exposures to indirect risks such as pension fund risk and to model the effect of management decisions, diversification, and capital fungibility. The second set of modules analyzes the insurer's modeling of exposure to "distinct" financial and nonfinancial risk groups like market risk, credit risk, operational risk, and insurance risk. Within each of the risks, we have articulated the criteria around five categories to be reviewed, namely: methodology, data quality, assumptions and parameterization, process and execution, and testing and validation. We will assign a score of "basic," "good" or "superior" to an insurer's approach for each category. At the conclusion of the ERM level III review, we will combine the scores assigned to each category within each risk to form an overall credibility assessment of an insurer's ECM."¹

Jennifer Nelson, Senior Vice President, Christopher Gross Consulting, Inc., stated that "As with many of the CAT models out there, S&P has a good understanding that the quality of ERM output is very dependent on the sophistication of the econometric model driving the scenario. Therefore a deeper look at the inputs and correlations within the model are necessary to develop an educated opinion about how valuable that data may be."

¹ "A New Level of Enterprise Risk Management Analysis: Methodology for Assessing Insurers' Economic Capital Models", Laura Santori et al, May 19th, 2010, Standard & Poors Financial Services LLC. Reprinted with permission

An initial conference call was held June 3, 2010 to discuss the proposed changes, and is available for replay at events.standardandpoors.com until July 1, 2010. In keeping with S&P's normal procedures, a technical session will be scheduled next, while a 60 day exposure period is being held to collect responses (comments can be sent to criteriacomments@standardandpoors.com). S&P expects to have final criteria ready by September, and to start conducting Level III reviews of select insurers by the end of 2010.

The complete report can be viewed online at www.aamcompany.com/news or it can be viewed at www.standardandpoors.com, along with other S&P reports. Please contact your AAM representative if you have any questions regarding this proposal from Standard and Poor's.

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