

The Actuary

DECEMBER 2011/JANUARY 2012 VOLUME 8 ISSUE 6



HOW TO HANDLE ORSA

Are you ready for the changes?

WITH REGULATORY CHANGES FOR U.S. INSURERS LOOMING ON THE HORIZON, THIS ARTICLE GIVES READERS AN IDEA OF WHAT TO EXPECT SO THEY CAN COME UP WITH A WINNING GAME PLAN. BY DAVE INGRAM

SEVERAL YEARS into the Risk Based Examination process, the National Association of Insurance Commissioners (NAIC) now is working to augment that process with a significant new risk related regulatory requirement for U.S. insurers. This new process, the so-called ORSA, or Own Risk and Solvency Assessment, moves insurance solvency regulation into new territory. Insurer and reinsurer management who will now be called to articulate their own judgment about the adequacy of their firm's capital may see this is an abrupt shift from the longstanding practice of regulators specifying the exact requirements for assessing insurer solvency. The new judgment from management is expected to better reflect the risks, risk management capacity and capital as well as the future plans of each insurer. Many of the largest insurers may have developed the capabilities and have been applying those capabilities for at least half a decade now, but mid-sized insurers may need to get to work.

This change comes from an agreement of the international insurance regulatory community for a set of Insurance Core Principles (ICPs) in October, 2010. The new requirement for solvency is recorded in ICP 16, titled Enterprise Risk Management. ICP 16 calls for an ORSA which is already embedded in Pillar 2 of Solvency II. In the United States, ORSA is currently under discussion for adoption by the NAIC later in 2011 or early 2012. Implementation by the states would follow in 2013 and after. In Bermuda it will be called the Commercial Insurers Solvency

Self Assessment. In Australia, it takes the same name as a similar process for banks, the Internal Capital Adequacy Assessment Process or ICAAP. Other regulators in other countries are expecting to join in. The Insurance Core Principles are a part of the enhanced regulatory thrust of the global Financial Stability Board under the authority of the G20 heads of state. The Financial Stability Board will be expecting a status report on implementation late in 2011.

WHY IS ORSA NEEDED?

In the past, solvency standards were always retrospective. They focused on past balance sheets to determine if an insurer had enough capital at the end of the last year for the risks that they held then. But what regulators really need to know is if an insurer has enough capital for the risks ahead.

Past solvency standards also focused on capital determination based on the regulator's estimate of the firm's risk. But the more important question is if there is enough capital for the risks as they really are.

As mentioned above, existing solvency standards make the regulator responsible for certifying solvency. The standards imply that if an insurer "passes," then the insurer has enough capital. But large U.S. banks that had "passed" the Basel II solvency standards succumbed to the economic crisis. Regulators have therefore decided to make the management and board responsible for certifying solvency, in hopes that they will do a better

job of reflecting the actual risk position and capital needs of the insurer.

REACTIONS TO THE NAIC'S ORSA PROPOSAL

The NAIC has exposed two different versions of an ORSA requirements for comments in late 2010 and in the spring of 2011. Reactions to the ORSA are mixed:

"We agree that introduction of an ORSA requirement into the U.S. solvency framework could provide regulators with meaningful insights into a company's risk management practices." — **American Academy of Actuaries**

"ACLI believes that consideration of the scope and effectiveness of an insurer's risk management framework should be an integral part of the supervisor's assessment of an insurer's solvency. Our members believe that an insurer must have a sound process for assessing its capital adequacy in relation to its risk profile. That process must be integrated into its management processes and decision making culture, and the culture must in turn embrace an active internal risk assessment and risk management processes. Our members would therefore support a requirement that an insurer regularly assess its reasonably foreseeable material risks to ensure that its total financial resources are adequate to meet its insurance obligations at all times." — **American Council of Life Insurers**

“The ORSA process should not mandate specific approaches but should focus on verifying that insurers are thinking about and managing their risk exposures.” — **Aegon**

“We urge the NAIC to be sensitive to the extraordinary effort that will likely be required of all carriers to complete a risk assessment appropriate to the company’s risk profile.” — **America’s Health Insurance Plans**

“We believe that the current U.S. solvency system is functioning well. ... During the recent period of major financial failures, the lack of insurer insolvencies has been a source of pride for the NAIC. This outcome suggests that the current solvency regulatory system is ample, if not robust. While there may always be room for improvement, it would be a stretch to suggest that the current system is broken and should be revamped. This proposal seems to increase the overall regulatory requirements without deriving tangible benefits.” — **Blue Cross Blue Shield Association**

“The criteria included in the ORSA proposal (particularly Section 1) would best fit, after appropriate changes, as examination guidance of common criteria generally found in ERM programs. It would provide a basis for examiner evaluation without setting out de-facto requirements for ERM programs. Such requirements would seem to cross the line between regulator and management. As ERM practices further evolve, it would be easier to change examination guidance rather than a model law or regulation.” — **Group of North American Insurance Enterprises**



“Many of the responses sought here would exceed thirty pages. Some, including those not listed, would require more—plus supporting schedules. Is it within the capabilities of the states to annually review such a behemoth compliance filing? ... How many different species of regulator-analysts would be required to competently review such annual filings?” — **National Association of Mutual Insurance Companies**

A new group, the North American Chief Risk Officers, provided extensive suggestions that proved to be in line with where the NAIC ended up with their October revisions. For the most part, they suggested that the ORSA should be the company process, without significant specifications from the regulators.

“The ORSA summary report should be organized into three major sections: Section 1—Description of the Insurer’s Risk Management Framework; Section 2—Insurer Assessment of Risk Exposures; and

Section 3—Internal Capital and Prospective Solvency Assessment. An internationally active insurer that completes its ORSA for a group-wide supervisor in a foreign jurisdiction may be able to satisfy the NAIC’s filing requirement by providing that ORSA report. One of the NAIC’s goals is to avoid creating duplicate regulatory requirements for internationally active insurers.

“The summary should describe how the insurer identifies and categorizes relevant and material risks and manages these as it executes its business strategy. It should also describe risk monitoring processes and methods, provide risk appetite statements, and explain the relationship between risk tolerances and the amount and quality of internal capital. Finally, it should describe how the insurer incorporates new risk information to monitor and respond to changes in its risk profile due to economic and/or operational shifts and changes in strategy.

“Additionally, as part of the risk-focused examination, the examiner may review supporting materials to supplement his or her understanding of information contained in the ORSA summary report. These materials may include risk management policies or programs, such as the insurer’s underwriting, investment, claims, asset-liability management (ALM), reinsurance counterparty and operational risk policies.

“Emphasis on flexibility and principles-based ORSA requirements. The Council recognizes that the NAIC would like to provide state regulators with a framework for evaluating the efficacy of each insurer’s internal risk and capital management processes. In presenting this framework, it is important to differentiate between fundamental and supporting risk management practices. While having procedures in place for material and relevant risks is fundamental to a risk management framework, we suggest that the specific supporting details will depend on each company’s self-assessment of risks and strategy. For this reason, we reiterate that there is no one-size-fits-all approach to an ORSA and company risk policies, procedures and management actions should differ according to the business strategy and risks. As such, we suggest that the NAIC’s Guidance Manual provide clear language indicating that each insurer’s risk management, policies and procedures will vary based on the self-assessment of material and relevant risks.”

NAIC GUIDANCE MANUAL

The NAIC has created an implementation *Guidance Manual* and issued an updated version in late July to react to some of the comments received. The new draft manual suggests that insurance groups will be exempted from the ORSA requirements if their U.S. premium writings are less than \$1 billion per year, and insurance companies with less than \$500 million are also exempted. According to NAIC statistics, this will capture at least 80 percent of the premiums while relieving a large number of smaller insurers.

IMPLEMENTATION REQUIREMENTS

The new ORSA requires the management and board to decide on the adequacy of the firm’s ERM system and capital, based on their own assessment of the firm’s future plans, risks and risk capacity. The risk capacity is calculated from the funds available and the quality of risk management systems.

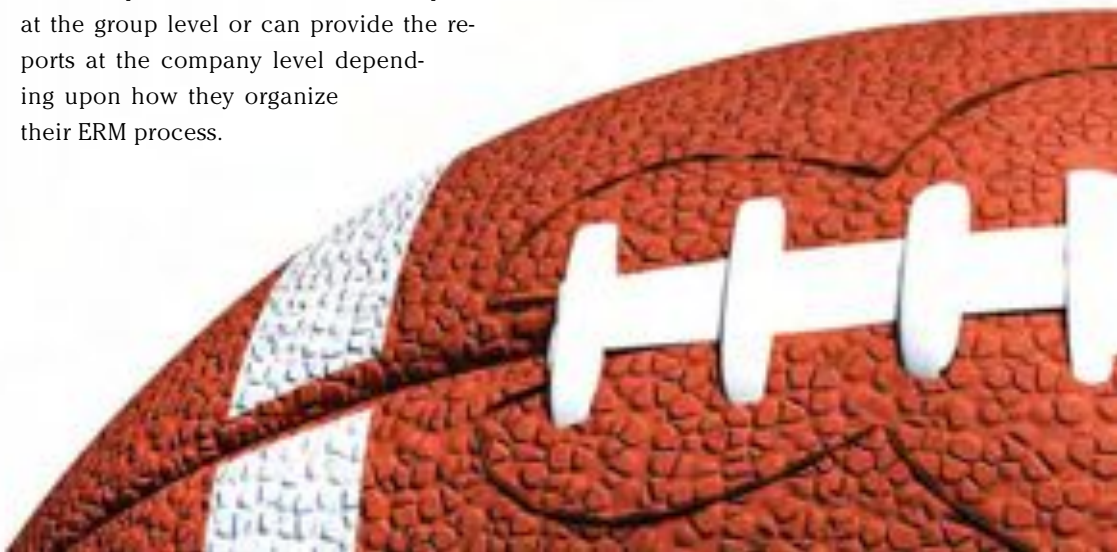
For a few insurers with large formal ERM programs already in place, the ORSA requirements will mean simply documentation of their ERM processes. However, the NAIC is expecting to require filing of only a three- to five-page confidential summary. U.S. companies that are a part of international groups filing an ORSA with the group will be able to file the same report in the United States. U.S.-based groups will be expected to create an ORSA report at the group level or can provide the reports at the company level depending upon how they organize their ERM process.

“Mandating legal entity-level presentation is also inconsistent with the premise that the ORSA should be an output of an insurer’s existing ERM environment and a regulatory resource to monitor that same environment. Most ERM programs look at risk holistically across an enterprise, recognizing where there may be concentration risks across legal entities, as well as diversification benefits. Viewing the risk at a legal entity-level is inconsistent with this approach.” — **Chubb**

But for some insurers, the new standards will require the establishment of more formal ERM processes and additional risk measurement capabilities. Boards and management will also need to be prepared for the initial ORSA summary report. They will need to stay updated on ORSA developments, as well as the firm’s risk management processes.

The ORSA will require a consistent and efficient measurement of solvency resources as well as a determination of capital quality. In addition, the ORSA will look for an effective ERM framework. The NAIC sees such a framework to include:

- Risk Culture and Governance;
- Risk Identification and Prioritization;
- Risk Appetite, Tolerances and Limits;



- Risk Management and Controls; and
- Risk Reporting and Communication.

They will look for documentation of this framework as the ERM policy statement of the insurer.

MINIMUM INTERNATIONAL STANDARDS FOR ERM ADEQUACY

ICP 16 that spells out the international standards is somewhat different from the NAIC approach. ICP 16 specifies nine major risk categories: Claims, Expense, Reserving, Investment Market, Counterparty Credit, Investment Credit, Operational, and Liquidity Group Risk. Insurers will need to be able to identify and track key indicators for each major risk.

For risk measurement, many requirements have been laid out. Insurers that have not yet developed significant risk measurement capabilities will find compliance with these requirements to be quite challenging. They will be expected to regularly assess the frequency and severity of identified risks using risk modeling techniques, stress testing and/or scenario analysis. These methodologies should be able to consider a range of levels of adversity as well as distributions of future cash flows. They should also be able to look beyond accounting and regulatory views. If they contain limitations, management and boards should be informed. Concepts such as parameter risk modeling, and qualitative assessments of reputation risk and other non-

quantifiable risks need to be considered. New stress tests should be performed, in addition to documentation of risk measurement approaches and assumptions.

Apart from risk measurement, ORSA calls for a Risk Feedback Loop. This is a new risk con-

QUANTITATIVE AND QUALITATIVE RISK ASSESSMENTS SHOULD BE PERFORMED. STOCHASTIC MODELING IS NOT SPECIFICALLY REQUIRED; IN FACT, THE ORSA PRACTICE SEEMS TO FAVOR STRESS TESTING.

cept, based on the idea that a new ORSA review process is required whenever there is a major change or potential change to the insurer's risk profile. This change could result from environmental factors, management actions, uneven growth or a decline in the risks of the insurer. In such circumstances, ORSA requires that insurers trigger a new ORSA, as well as a reassessment of risk tolerance and risk treatments.

The development of a Risk Tolerance Statement is known to stymie most insurers. However, insurers will need to overcome their reluctance to complete this step. Quantitative and qualitative risk tolerances and limits must be set and reflected in business strategy choices as well as day-to-day operations. It requires calculating financially the strength, size and complexity of risks; resources needed to manage risks; and transferability of businesses.

Once risk tolerances and limits have been set, the required risk policy statements will largely be a documentation

of these practices. The policies will summarize how relevant risks are identified, managed and monitored at the operational level. It will also report how risk information links to the company's strategy development processes, in addition to explaining the relationship between risk tolerance and capital

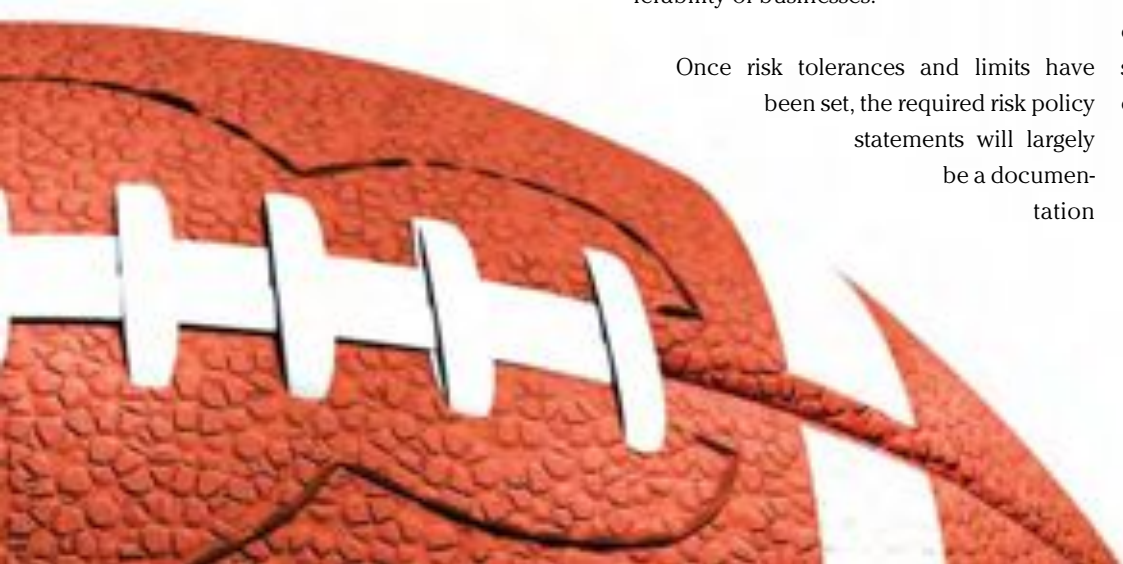
held. Specifically, ICP 16 calls for policies regarding the underwriting of risk, asset liability management and investment risks. It also requires a policy statement that documents the risk feedback loop.

SOLVENCY REQUIREMENTS

Most firms will focus on the ORSA resource assessment or measurement requirement. ICP 16 specifies that the ORSA needs to plan ahead for up to five years to represent the business plan of the insurer while the *NAIC Guidance Manual* allows for a two-to five-year look forward. All foreseeable and material risks should be included in the assessment. Quantitative and qualitative risk assessments should be performed. Stochastic modeling is not specifically required; in fact, the ORSA practice seems to favor stress testing.

The NAIC suggests that insurers need to calculate economic capital and to specify seven major decisions that they made in calculating economic capital:

1. **Definition of solvency**—Cash flow basis, balance sheet basis or other.
2. **Time horizon of risk exposure**—One year, lifetime or other.





used as the basis for the capital held, the ORSA will require that insurers prepare a view of the adequacy of capital in a stressed environment. Insurers will need to develop processes to perform a self-assessment in the stressed environment using either a stress testing methodology or a stochastic model. And since the ORSA requires a multi-year view of future capital needs, even firms that have developed internal models may want to enhance the scope of their models to provide multi-year projections. Otherwise, they will need to create alternative processes to look ahead over several years and get the board and management to sign off on the resulting conclusions.

HOW OFTEN MUST ORSA BE UPDATED?

The NAIC has specified that the ORSA must be prepared annually as the minimum schedule. In addition, ICP 16 specifies a number of situations that would trigger the need for a new ORSA. These include:

- Occurrence of a major change—actual or likely;
- Startup of new lines of business;
- Major changes in risk tolerance limits and/or reinsurance arrangements;
- Aggressive acquisition strategy to win market share;
- Acquisition of other insurers and/or portfolios;
- Aggressive strategy to improve risk profile;
- Major changes to premium levels;

- Disposal of existing portfolios;
- Major changes to capital distribution (e.g., dividend payment or share repurchase) or capital injection;
- Major changes in asset mix;
- Major changes in external risk factors; and
- Major changes in business conditions such as in the competitive, regulatory or legal environments.

It is unclear whether the NAIC will have any process for reviewing an ORSA report anything other than annually.

CONCLUSION

ORSA requirements may present a new challenge for some insurers. While the consequences of noncompliance have not yet been specified, they could range from additional scrutiny during the regulatory review process to public reports declaring the inadequacy of the firm's risk management practices. The exact ORSA process that will be required of U.S. companies is still evolving. The NAIC is clearly working with the feedback that they are getting to adapt the ideas of the ICP 16 to fit with the existing regulatory and industry situation here in the United States while achieving the objectives of ICP 16.

The main ideas of the ORSA—that the insurer (not the regulator) should be responsible for determining the capital that the firm needs; and that the determination should reflect the risk management capabilities, the risks and the capital of the firm—are strongly in place. ■

Dave Ingram, FSA, CERA, MAAA, is executive vice president with Willis Re Inc. He can be contacted at dave.ingram@willis.com.

3. Risks modeled.

4. Risk measurement process—Stress tests, stochastic modeling, factors.

5. Measurement metric—Value at risk, tail value at risk, probability to ruin, or other.

6. Company target level of capital.

7. How diversification is reflected.

In Europe, regulators expect that the parameters for the ORSA may be different from those of the internal model submission for Solvency II capital adequacy purposes. This is because the internal model submission is calibrated on the risk assumptions specified by the regulators, while the ORSA will be calibrated to reflect the risk assumptions of management.

While the NAIC allows for factor models to be