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ORSA—A Regulator's Point of View

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> ORSA is one tool, among others, used by an insurer to guide risk-taking activities and focuses on risk identification and solvency.

Assessing their own risks and capital needs to reduce the risk of insolvency is not a new concept for life and property and casualty (P&C) insurers, but supervisory expectations (e.g., Solvency II in Europe) and industry best practices have evolved over time, especially in recent years. In Canada, since Jan. 1, 2014, the Office of the Superintendent of Financial Institutions (OSFI) has required each federally regulated insurer to carry out an Own Risk and Solvency Assessment (ORSA) and to present their process and results in a report to its board of directors (board).

OSFI does not approve an insurer's ORSA, but in its normal course of supervisory monitoring, may review the ORSA process, including reports to the board. Similarly, ORSA reports are not normally required to be submitted to OSFI, except for the initial reports prepared in 2014. However, each insurer must annually complete an OSFI-prescribed Key Metrics Report (KMR) and submit it to OSFI.

This article highlights some of OSFI's expectations regarding the ORSA process, and provides general feedback and observations from OSFI's reading of 2014 ORSA reports (including KMR) and discussions with insurers.

ORSA AND ERM FRAMEWORK

OSFI's Corporate Governance Guideline states that *"A FRFI [federally regulated financial institution] should have a Board-approved Risk Appetite Framework that guides the risk-taking activities of the FRFI."* While enterprise risk management (ERM) focuses on the management of risks toward a well-defined risk appetite, ORSA is one tool, among others, used by an insurer to guide risk-taking activities and focuses on risk identification and solvency. ORSA is a process by which an insurer identifies its material risks, assesses its capital needs and determines or changes its internal capital target. The ORSA report and KMR are outputs and documentation of the process.

The oversight of the ORSA process is the board's responsibility. The board should gain comfort with the reasonableness and appropriateness of the ORSA results in the context of board-approved risk appetite and risk limits.

ORSA BENCHMARKING

OSFI has performed a preliminary review of more than 125 life and P&C ORSA reports, focusing on expectations from Guideline E-19[1] ("Own Risk and Solvency Assessment"), approaches used by insurers, qualitative assessments and KMR filings. Observations are broadly similar in the P&C and life industries.

Different approaches adopted by insurers for the ORSA process are reflected in the types of ORSA reports prepared. In fact, OSFI has found that insurers are largely taking one of three approaches:

- Treating ORSA as a compliance exercise: These ORSA reports generally tend to be short and to the point, with little information that would be useful for strategic planning or understanding of the institution's risk profile.
- Communication or risk summary: These ORSA reports generally provide a qualitative discussion and typically include a reasonable amount of details on methodology and critical assumptions.
- Description of process and conclusions: Many ORSA reports described the process at length. A few were also very technical in nature.

Reports ranged from four pages to over 200 pages, with a number of reports being descriptive in nature.

Here is a summary of a number of key findings:

LINK TO INTERNAL TARGETS

Most (67 percent) of the ORSA reports identified internal capital targets, but only 25 percent of those targets were equal to the internal capital target shown on the KMR. This suggests that many insurers were not, contrary to OSFI's expectations (as stated in Guideline A-4,[2] "Regulatory Capital and Internal Capital Targets"), using the ORSA to establish their internal capital targets. It was noted that many insurers kept their internal capital targets at pre-2014 levels, without explanation on how it tied to the ORSA.

Operating levels of capital and Tier 1 internal capital targets (for life insurers) were usually not discussed in the ORSA reports.

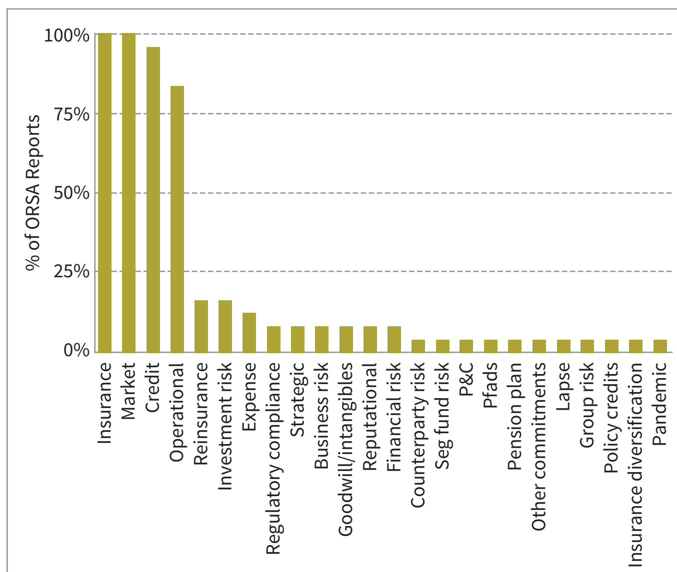
RISK IDENTIFICATION

There was no standard definition of risk categories, attesting to the diversity of views on risk. For example:

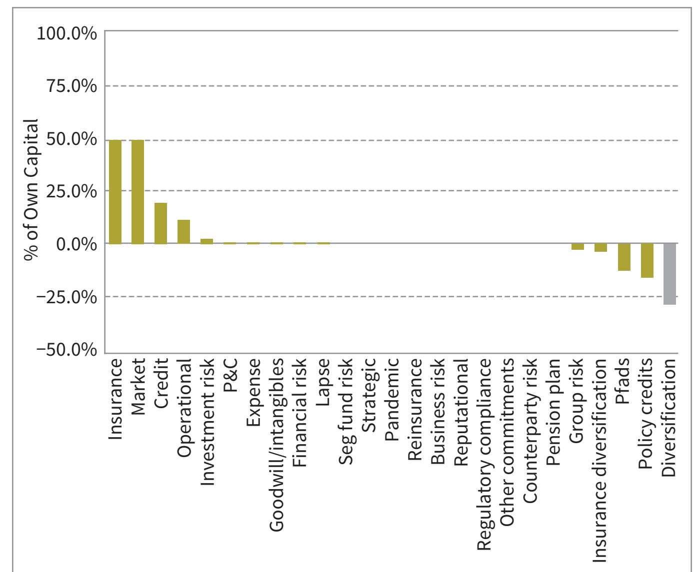
- Insurance risk:
  - o In some cases, catastrophe risk or reserving was a separate risk category.
  - o Some definitions included reinsurance risk.
- Credit risk:
  - o In many cases, it was strictly reinsurance counterparty credit risk.
  - o Credit risk sometimes included policyholder and broker counterparty credit risk.
  - o Other definitions were investment-based.
- Market risk:
  - o Foreign exchange risk was sometimes included in market risk or as a separate category.

Given this diversity of views on risk, adding up and comparing own capital by risk categories at an industry level may not be meaningful.

In the life ORSA reports, as an example, a total of 24 risk categories were separately identified, as follows:



Here is how life insurers assigned their own capital to these 24 risk categories:



QUANTIFICATION METHODOLOGY

Some ORSA reports provided a good overview of methodologies or provided a reference to supporting documentation. Having said this, DCATs,[3] MCCSRs[4] and models (VaR,[5] CTE[6]) were often referenced, but an explanation of how these integrate in the ORSA process was sometimes lacking.

STRESS TESTING OWN CAPITAL

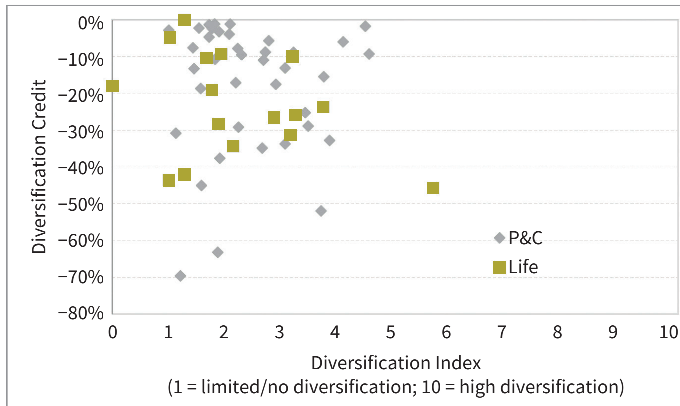
Only a small number (13 percent) of ORSA reports included insurers' own capital for stress testing scenarios. Some ORSA reports included an amount to bring the ORSA capital to the internal capital target level. This amount is necessary in situations where an insurer has determined that its own capital needs are not sufficient to meet external or third-party capital expectations (e.g., credit rating agencies, OSFI and other regulators).

The primary severity (confidence) level (used by more than 40 percent of all insurers) was 0.995 (1-in-200) and some insurers used different severity levels for different risks.

DIVERSIFICATION METHODOLOGY

OSFI found that 16 percent of the reports used the correlation approach of OSFI's current regulatory capital requirements (MCT[5]/MCCSR). For most of the other reports, representing nearly half of all ORSA reports, however, the diversification methodology was unspecified.

Seventy percent of ORSA reports identified taking diversification credits, with maximum credits of 70 percent for P&C and 46 percent for life insurers. The following graph shows diversification credits as a proportion of the insurer's own capital:



As can be seen from the chart above, a number of less diversified or less complex institutions (i.e., those showing a low diversification index value) are fairly aggressive in taking diversification credit, while some more complex institutions are not.

OTHER OBSERVATIONS

Most insurers have not yet fully incorporated their ORSA processes as part of their ERM or strategic planning.

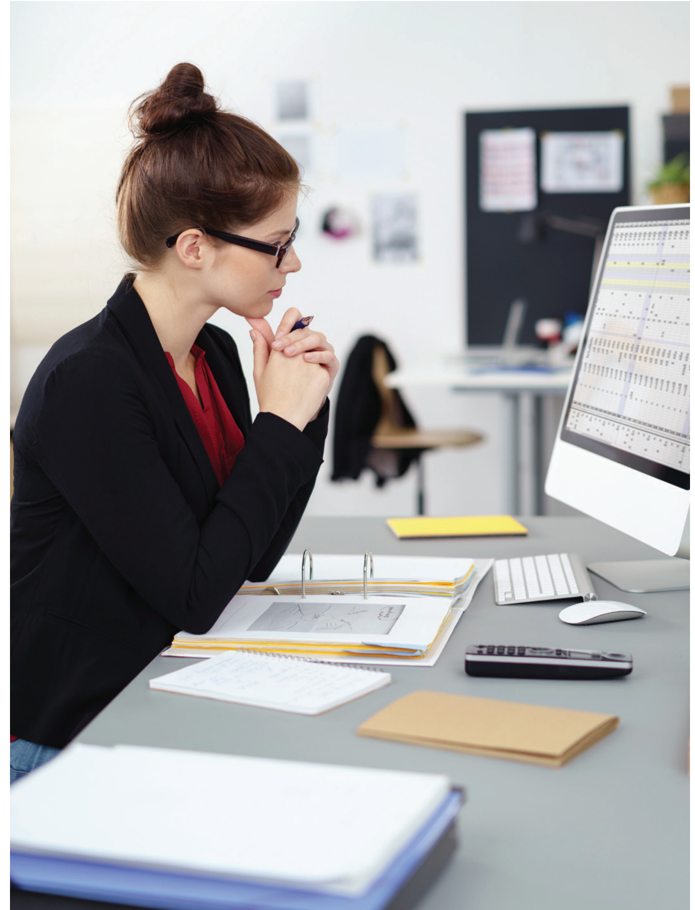
Although most insurers referenced in their ORSA reports their ERM processes, policies related to risk, risk appetite and tolerances, as well as their DCAT, only half of them referenced emerging risk processes and the issue of capital fungibility (quality of, or access to, capital was rarely discussed) and only a few referenced (or used) reverse stress testing.

Many insurers included in the ORSA reports a gap analysis of their ORSA processes. Insurers have indicated several future planned enhancements, including improvements to their models and stress testing, more research on understanding their risk profiles, better quantification of operational risk, enhanced understanding of aggregation and diversification, as well as better integration with ERM processes and business planning.

REVIEW OF KEY METRICS REPORT

The KMR is an OSFI requirement and must be filed annually by insurers with their OSFI lead supervisors. For the KMR, insurers must comply with the following:

- The KMR template should not be modified.
- All figures should be consistent with figures included in the ORSA report. (KMR is a summary of how insurers have related their risks to capital.)
- Must be submitted to OSFI within 30 days of the ORSA report being discussed with the board or chief agent.



In reviewing the filings, OSFI found that most of them had deficiencies, including amounts not reconciling to, or inconsistent with, the amounts in the ORSA report (e.g., internal capital targets shown on the KMRs being different from the internal capital targets identified in the ORSA reports), as well as insurers modifying OSFI's KMR template. Instructions for completing the KMR have since been updated, in part, to provide better clarity to insurers on preparing this report.

SUPERVISORY FEEDBACK

Although OSFI may be in a good position to recommend enhancements to an insurer's ORSA report, it has no plans to do so. The primary reason for this is because ORSA is meant to be each insurer's **Own** Risk and Solvency Assessment. If OSFI were to make specific suggestions to individual insurers, it would inadvertently substitute its judgment for that of the insurers. Moreover, it is very difficult to assess an ORSA process solely on one or two output documents. As such, OSFI will not comment on the structure of an ORSA report, specific risks identified or the general content of the report.

Having said the above, supervisory feedback may be provided in certain circumstances. For example, if:

- There is clear inconsistency with Guidelines A-4 or E-19 expectations (e.g., ORSA process is not used to set an internal capital target).
- There is inconsistency in reporting between the KMR and the ORSA report (e.g., numbers do not align).
- The insurer does not have an annual process in place to update the ORSA.
- An objective review plan has not been identified.
- There are methodological concerns with the internal capital target setting (e.g., methodologies around diversification, etc.).

Given that ORSA was only introduced in 2014, insurers' ORSA processes are expected to improve and mature in the coming years. It is recognized that it may take some (undefined) time to get ORSA processes to where they need to be. Generally speaking, more time may be required for smaller insurers, while less time may be required for larger ones. ■

ENDNOTES

1. http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/e19.aspx
2. http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/a4_gd.as
3. Dynamic Capital Adequacy Testing.
4. Minimum Continuing Capital and Surplus Requirements.
5. Value at risk.
6. Conditional tail expectation.
7. Minimum Capital Test.

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