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Understand ORSA Before Implementing It

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THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC) is moving forward to implement a new regulatory requirement that requires U.S. insurers to perform an Own Risk and Solvency Assessment (ORSA). Before developing a response to the ORSA requirement, insurers will want to understand its genesis and the underlying rationale for it, as well as its implications. This article provides an overview of the evolution and rationale for ORSA, as well as practical implications for insurers as they begin to design an ORSA process.

THE EVOLUTION OF ORSA

The new ORSA requirement is one component of the NAIC's initiative to bring the U.S. regulatory regime into alignment with the Insurance Core Principles (ICPs). The ICPs are developed by the International Association of Insurance Supervisors (IAIS) and outline "the requirements for an effective insurance supervisory system." Almost 200 countries, including the United States, have joined the IAIS and all have agreed to be bound by the ICPs. The International Monetary Fund and World Bank regularly review these countries—through a Financial Sector Assessment Program (FSAP)—to ensure that local insurance regulation meets the ICP principles.

To date, the U.S. insurance market has not fully appreciated the extent to which insurance regulation is being "globalized" through the IAIS, around the ICPs. The ICPs are international mandates and, as the largest insurance market in the world, the United States faces tremendous political pressure to adhere to them. Given its prominence, the United States has started to direct its political influence toward the evolution of the ICPs through active participation in the IAIS. This activity will continue with the new Federal Insurance Office, which will work with the NAIC to effectively influence ongoing regulatory developments at the IAIS.

The U.S. ORSA is a byproduct of the ICPs. ORSA requirements established in the United States, and abroad, must meet the minimum standards set out in ICP 16—Enterprise Risk Management for Solvency Purposes. ICP 16 requires the supervisor to establish enterprise risk management standards that require

insurers to identify, assess and address all relevant and material risks. Specifically, ICP 16.11 states that, in an effective insurance supervisory system:

The supervisor requires the insurer to perform its own risk and solvency assessment (ORSA) regularly to assess the adequacy of its risk management and current, and likely future, solvency position.

The United States is not alone in implementing new ORSA requirements. For example, similar requirements are being established in Canada, Bermuda, Japan and Australia, as well as all of Europe. Others in Asia and Latin America will likely follow suit. In general, these regulators expect "reciprocity," such that an ORSA prepared for one jurisdiction will satisfy the requirement in others.

ICP 16 is about 30 pages in length, and insurers embarking on ORSA implementation would be well-served to review the entire document to understand the underlying drivers behind the new NAIC requirement. While the U.S. ORSA requirement has some unique features, it will meet these basic requirements. That said, a few points are worthy of further discussion.

ORSA—IT'S A PROCESS

In assessing the implications of ORSA, one must differentiate between (a) the ORSA process itself, and (b) the ORSA regulatory requirement.

The ORSA Process

The ORSA process is an internal activity of the company, which consists of—what most would consider—good enterprise risk management. In essence, it is an internal assessment of the risks associated with an



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insurer's business plan, and the sufficiency of capital resources to support those risks. It includes ongoing processes to support:

- Risk identification and prioritization
- Risk measurement
- Articulation of risk appetite and tolerances
- Implementation of risk limits and controls
- Development of risk mitigation strategies
- Capital adequacy assessment
- Governance and risk reporting.

ORSA's defining element is the linkage it creates between risk management, capital management and strategic planning. Within the ORSA, the company is expected to self-assess its current and future capital adequacy in light of its two- to five-year business plan.

The ORSA Requirement

Beyond establishing an ORSA process, insurers will need to prepare materials to evidence the efficacy of the process to external parties. The NAIC's *ORSA Guidance Manual* indicates that those insurers required to conduct an ORSA will also be required to provide a high-level summary report annually to the domiciliary regulator, if requested. The three sections of the ORSA Report will (1) describe the company's enterprise risk management program; (2) summarize the company's

risk assessment for each material risk; and (3) describe how the company aggregates individual risk assessments to determine the level of financial resources it needs for its current business, and for its planned business over its planning horizon.

In addition to the ORSA Report, companies will be required to assemble and maintain documentation of all aspects of their ORSA process, which may be used for more in-depth on-site reviews. ORSA materials will eventually be integrated into regulatory examinations, helping state insurance departments determine the scope, depth and timing of each insurer's exam and informing the state regulator's new risk-focused examination approach.

ORSA—PRACTICAL CONSIDERATIONS

At its core, the original purpose of the ORSA was to foster internal risk management within each insurer, enhance management awareness of the interrelationships between risks, and increase understanding of the relationship between overall risk exposure and the capital needed to support it. A predicate belief is that better internal risk management at all insurers is in the public interest because it will reduce insolvencies and enhance capital efficiency across the global insurance industry. The original proposers articulated a number of principles for the ORSA. For example, an ORSA should:

- Be the responsibility of the company
- Incorporate a forward-looking assessment of all material risks
- Be embedded into the decision-making processes of the business.



While some companies may choose to treat the ORSA as an entirely new regulatory reporting requirement, that is not the intent, and insurers will be missing an opportunity if they approach it in this manner. Instead, companies should recognize that the ORSA encompasses most of what is considered good risk management practice (see figure below), and that the ORSA requirement should therefore serve as a catalyst for implementing risk management internally.

Of course, to genuinely foster risk management, insurers must be allowed to develop and conduct their

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ORSAs in a manner that is consistent with the scope and scale of their business, internal culture and management structure, and chosen approach to enterprise risk management. The NAIC’s *ORSA Guidance Manual* explicitly recognizes that each insurer’s ORSA process will be unique, and currently provides insurers relative latitude in the design of the internal ORSA process. Thus, insurers have the opportunity to leverage much of their existing enterprise risk management capabilities to develop an ORSA process that is maximally useful to the management of the business. In addition, it affords companies the ability to evolve their ORSA over time, in light of successes and failures. The insurance industry, and particularly the North American CRO Council, has worked hard over the last few months to limit the introduction of prescriptive requirements into the conduct of an ORSA. From a policy standpoint, the introduction of ORSA will not be of benefit to the public if it evolves into a highly prescribed regulatory compliance exercise, and the industry will need to continue to resist efforts to add prescriptions that will make it so.

Embedding the ORSA process into business planning is fundamentally important. An effective ORSA will be more about process than results. Unlike risk-based capital, where every company has an “RBC ratio,” there will be no “ORSA score” at the culmination of the ORSA exercise. Instead, ORSA effectiveness should be gauged by the extent to which it is integrated into decision making and planning, both at the strategic and the day-to-day level. Effectiveness of processes, such as monitoring for adherence to risk limits—consistent with the adopted risk appetite—are key to the implementation of ORSA. Ultimately, the litmus test for ORSA will be how management responds to the next financial crisis or threat. To this end, the NAIC has placed great emphasis on fostering an interactive dialogue between financial examiners and executive management on the process itself—not just the numeric output.

To further this point, an effective ORSA will be more qualitative than quantitative. While it will be natural for actuaries to think of the ORSA as essentially just another application for their financial models, that is also not the intent. In fact, the NAIC’s *ORSA Guidance Manual* does not even require the insurer to employ an economic capital model. Stress-testing of the financial

balance sheet against regulatory and rating agency capital requirements could be sufficient, if that is how the company chooses to internally manage risk. In essence, the ORSA needs to balance and integrate the quantitative risk analysis with qualitative risk management processes.

It should also be noted that an important aspect of ORSA is that it is to be conducted on a group-wide basis. This makes eminent sense, as that is how the business is ultimately managed. Larger companies may choose to conduct ORSAs within major business segments, and then aggregate up from there. Given that the goal is to integrate the ORSA into decision making, decisions about how to organize the ORSA will vary from company to company, depending on how they choose to organize themselves for other purposes. Some have suggested that ORSA Reports be prepared for each legal entity, as well as the group as a whole. This makes little sense. While there is sometimes coincidence between business segments and legal entities, this is more often not the case.

Finally, ORSAs will eventually serve as a source of information for the regulators about the insurer’s risk management program and capabilities, as well the risks it faces and its internal capital resources. While this certainly has the potential to enhance supervision, particularly if it is used to focus regulatory examinations on key risk issues, it will require the development of stronger risk management capabilities within the supervisory community before such information can be effectively utilized. Supervisory staff will need to be able to differentiate between strong and weak risk management practices, requiring skills that are typically not present in many state insurance departments. In addition the information will not be uniform across companies (by design), which is countercultural to most regulatory environments. As the ORSA requirement is implemented, we should expect natural pressure from supervisors to try to establish additional standard reporting requirements to facilitate “benchmark” comparisons across companies, and standard reporting formats to facilitate checklist reviews. The insurance industry will need to resist these

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pressures, to the extent that they are counterproductive to the intended purposes of the ORSA.

In sum, ORSA is an insurer's internal process of self-assessing its material risks and evaluating the capital to support them. The design of an ORSA process should consider the insurer's existing enterprise risk manage-

ment framework and focus on balancing quantitative and qualitative elements. Ultimately, the test of a successful ORSA lies in its ability to improve the insurer's risk and capital management processes and influence strategic decisions. Finally, the ability to communicate the process to regulators will be fundamentally important given the unique nature of the ORSA information. ■

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