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NAIC ORSA

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GUIDANCE MANUAL

The latest draft ORSA Guidance Manual was released on Oct. 14, 2011. An overview of the requirements from a qualitative, quantitative and governance perspective was provided in the December edition of the Financial Reporter. Several trade associations and companies commented on the draft. The main comments and recommendations were:

- Several organizations and companies expressed concerns that the ORSA could lead to additional regulatory solvency requirements and become the new solvency standard. This is primarily based on several references in the Guidance Manual such as "capital adequacy," "security standard," "risk capital requirements" and "target level of capital";

- There were also concerns about the possibility that regulators could have some input into the selection of the various stress tests, measurement metrics (VaR, etc.) and the parameters underlying the economic scenario generator, therefore influencing the level of risk capital that company might be expected to hold;

- Concerns were expressed about the lack of a level playing field between insurers or groups if the regulators could potentially use the quantitative results of the ORSA as a basis for regulatory action. Companies that take a more conservative view could be at a disadvantage relative to insurers that take a less conservative approach or because of differences in quantification methods (stress tests, stochastic simulations, factor-based), accounting framework (economic, rating agency, regulatory), time horizon (one year vs. lifetime) and measurement metrics (value at risk, tail value at risk, probability to ruin);

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- There was general support for the pilot project in 2012 proposed by the NAIC Global Solvency Issues Working Group, preferably open to all insurers and groups as opposed to a select group, that would provide a field test of the manual and help assess if the ORSA provides meaningful information in relationship to the efforts required to produce it; and

- Most respondents would like more specificity around the concept of Lead Regulator so that groups would only need to prepare one ORSA Summary Report to be filed with the Lead Regulator which would be acceptable to multiple jurisdictions.

ORSA SUBMISSIONS AND ORSA MODEL ACT

The Guidance Manual had initially identified the reporting vehicle as Form B of the *NAIC's Insurance Holding Company System Regulatory Regulation.* Form B is an annual registration statement that must be filed by each legal entity. The industry raised several issues with this approach. The key concerns with using Form B were:

1. The lack of uniformity (not all states use Form B);

2. The potential lack of confidentiality as some states indicated they consider Form B public information;

3. It contradicts the concept of a single ORSA Summary Report to be submitted to the Lead Regulator, as Form B needs to be filed for each legal entity with their state regulator; and

4. It would not allow for flexibility in the filing timeline to reflect company practices with regards to their ERM, business planning and capital evaluation processes.

Industry drafted a stand-alone ORSA Model Act as the manual's reporting vehicle alternative to the Form B proposal. This act was also submitted for comments. Most of the comments received were consistent with those on the Guidance Manual and focused on:

1. Maintaining confidentiality of the ORSA Report and the supporting documentation. In particular, the industry is not comfortable with the idea of the states sharing information with the NAIC as it is not a state regulator and may lack privacy protection;
2. Clarifying the roles and responsibilities of the insurers/groups and of the Lead Regulator in order to make the ORSA Summary Report and the supporting documents available to all relevant regulators in an effective manner; and
3. Firming up the effective date and expectations around the timing of the ORSA Summary Reports. The proposed effective date of Jan. 1, 2015 requires more clarity as to when the first ORSA report would be due and the as-of-date of this report.

IMPLEMENTATION CONSIDERATIONS

Companies that have robust ERM frameworks and Economic Capital Models will have less difficulty preparing the initial ORSA from a qualitative and quantitative aspect. The most challenging component will likely be the development of a forward looking view of risk capital and the integration with the business planning process. Factor-based techniques based on limited stress-tests and sensitivities might make it difficult to reflect the development of the risk profile over a two- to five-year horizon (as indicated in the Guidance Manual), adequately reflecting changes in economic conditions, product mix, investment strategies, reinsurance, etc.

As part of the prospective solvency assessment, projecting risk capital under different scenarios will also be problematic as the existing models may not be flexible enough to prospectively adjust the risk measures, correlation factors and diversification benefits under significantly stressed scenarios.

Although not specifically required, the potential need to perform reverse stress-testing also presents difficulties as it implies the identification of scenarios that would have a material impact on risk capital after taking into account management actions and fungibility of capital across legal entities.

There is an expectation that the ORSA will be performed at least annually and updated upon occurrence of significant events or changes in the economic or business environment. This will require a robust and flexible ORSA process.

The development of "lite models" might be a potential solution for developing a forward looking risk capital assessment. Lite models are simplified versions of the more robust internal models (or Economic Capital models) and can be calibrated to capture the key characteristics and drivers of risk capital. They can also prove valuable in supporting business decisions through a better understanding of how the business strategy impacts the development of risk capital which is one of the expected benefits of the ORSA.

LESSONS LEARNED FROM SOLVENCY II

European insurers have been developing an ORSA

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as part of the Solvency II implementation. This has possibly been one of the most challenging aspects of Solvency II due to the lack of clarity around regulators' expectations and the format of the ORSA report, the need to demonstrate how the ORSA is embedded into business decisions (the Use-Test) and having to reconcile the ORSA risk capital to the Solvency II Solvency Capital Requirements determined using internal models.

The adoption of the NAIC ORSA appears to be on a fast track and insurers need to gain a good understanding of the requirements and expectations and how they will impact their organization. The ORSA will likely impact several aspects including risk management, strategic planning, capital management and regulatory reporting. In defining their implementation approach, insurers should consider the value that can come out of the ORSA, especially from developing a forward-looking view of risk capital. ■