Article from:

The Financial Reporter

December 2011 – Issue 87

U.S. ORSA Developments

By Seong-min Eom

Seong-min Eom, FSA, MAAA, is a manager for KPMG in New York, N.Y. She can be contacted at seom@kpmg.com.

In the United States, an Own Risk and Solvency Assessment (ORSA) Guideline is being developed by the NAIC Group Solvency Issues (EX) Working Group co-operating with the Corporate Governance (EX) Working Group as a part of the Solvency Modernization Initiative (SMI). According to the SMI roadmap,[1] an ORSA guideline is scheduled to be adopted by the end of this year, and an ORSA model law is planned to be developed and implemented by December 2012. This article is based on the ORSA draft exposed on Oct. 14, 2011.

The Solvency Modernization Initiative is a critical self-examination launched in June 2008 by the NAIC to update the U.S. insurance solvency regulation framework. It includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation.

The workplan[2] for SMI includes:

- Articulation of the U.S. solvency framework and principles;
- Study of other sector's and others countries' solvency and accounting initiatives and the tools that are used and proposed;
- Improved tools for risk-focused examinations;
- Creation of a new reinsurance regulatory framework;
- Movement to principle-based reserving for life insurance products;
- Consideration of possible change to group supervisory methods; and
- Implementation of new ideas to incorporate into the U.S. solvency system.

The ORSA is linked to most of the items in the SMI work plan as the ORSA covers overall enterprise risk management framework and processes. Through ORSA, U.S. insurance regulators would require insurers to establish a proper level of enterprise governance and a comprehensive risk management framework; this would involve processes, functions, and allocation of proper resources integrated with risk capital management adequate for the recognized risks under various business conditions including stress scenarios to support the insurer's solvency. The ORSA should be prepared consistently with how the business is managed, either on a group, legal entity, or other basis.

Many interested parties are concerned with the NAIC's timeline of developing an ORSA-type guideline by December 2011. These parties suggest extending the timeline so that the ORSA guidelines will be able to incorporate the broad range of ERM practices and other jurisdictions' ORSA development processes. In addition, they would like the ORSA guideline to be better harmonized with the U.S. legal framework and regulatory requirements, which are currently evolving significantly such as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), development of the Federal Insurance Office (FIO) proposed under the Dodd-Frank Act, or the addition of Form F, a new annual reporting requirement for insurance holding company systems in the amendment of the Model Act. There is a concern that a rapid introduction of an ORSA guideline could unnecessarily add another dimension of complexity and compliance to the insurance industry.

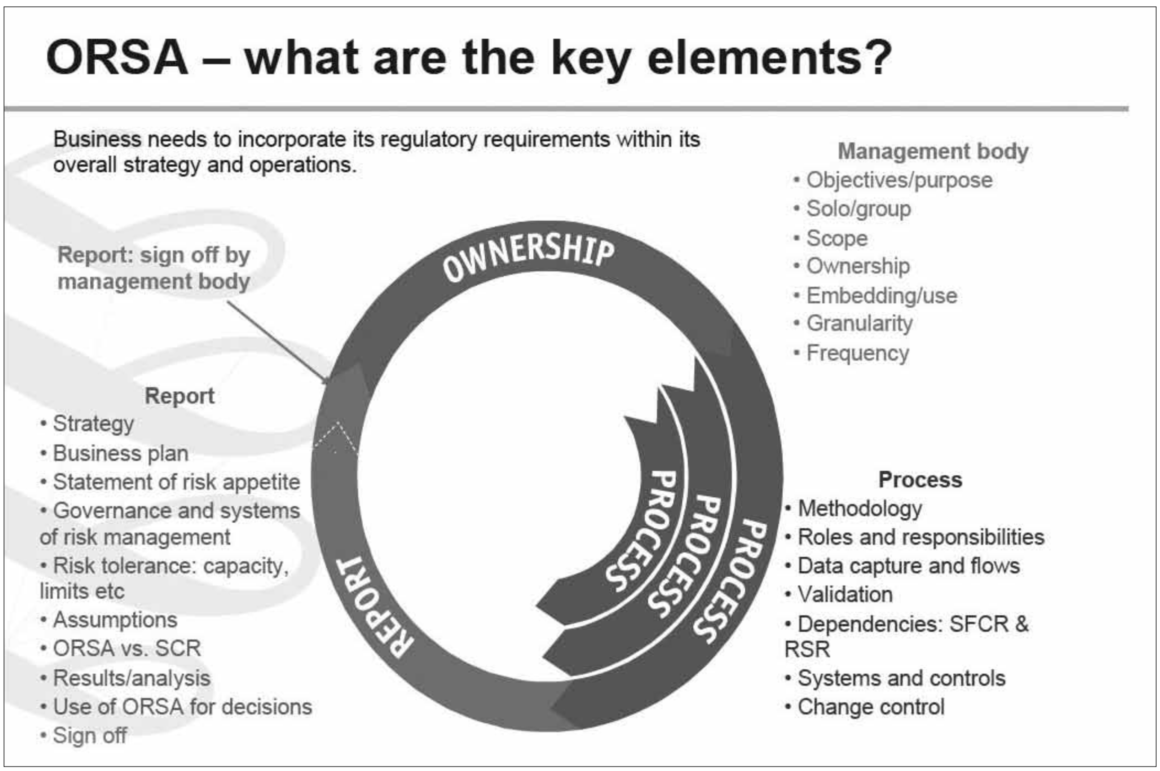
THE PURPOSE OF THE ORSA

The purpose of an ORSA is to promote insurers to have:

- a comprehensive risk management framework;
- risk management processes that identify, prioritize, measure, monitor and manage risks with forward-looking views;
- well-established internal control of risks that are reflected in stress-testing scenarios, assumptions, or internal models;
- good risk management reports and communication protocols; and
- capital management and capital actions that are integrated with risk management and internal controls.

The purpose and general characteristics of the U.S. NAIC ORSA and the EU Solvency II ORSA are very similar. It is intended that insurance companies will be able to connect their business strategy and risk measurement to capital planning and management. Both ORSAs support a robust company risk management framework with risk appetite and risk tolerance influencing the day-to-day business operations. The ORSAs request clearly established roles and responsibilities of the board of directors and senior managers of the company for risk management processes and suggest having a full picture of the risks of the company. They are not static formula-based approaches. ORSA is a flexible and dynamic enterprise risk management tool, reflecting the view of the company's business from the management group, the objectives of the company, nature of the business and the complexity of the products.

KEY ELEMENTS OF THE ORSA



The picture above exhibits the elements of ORSA and how the elements flow to meet the ORSA requirements. Because it is extracted from an FSA Solvency II educational briefing,[3] the ORSA elements in the picture are more oriented to the ORSA concepts under Solvency II. Still, most of the elements are directly applicable to the U.S. NAIC ORSA. This illustrates that the major elements of ORSA are linked to each other. The risk management governance of the insurer can directly impact the risk management processes and controls in each business unit, and these processes and controls will be reflected in risk management reporting. Then, based on the reports, management will again review the risk management framework including the individual processes.

CONTINUED ON PAGE 18

THE THREE SECTIONS OF THE NAIC ORSA

The NAIC ORSA is composed of three sections:

- Section 1: Description of the Insurer's Risk Management Framework;
- Section 2: Insurer's Assessment of Risk Exposure; and
- Section 3: Group Risk Capital and Prospective Solvency Assessment.

Section 1 guides insurance companies/groups in establishing a holistic enterprise risk management framework. The ORSA requests insurers to submit a document describing the insurer's risk management framework and principles. Section 1 is intended to support qualitative risk management. The risk management policies should include the insurer's tailored risk categories, how the risks in each category are identified, assessed and monitored in the insurer's regular business operation. The risk management policies should describe the risk control and mitigation activities. The group risk management process and policies need to be disclosed. Section 1 of the ORSA also requests information about the risk management processes and risk assessment tools that are used to respond to the changes in the insurer's internal and external business circumstances or business strategy.

Section 2 covers quantitative risk exposure measurement in both normal conditions and in a stressed environment. Insurers should show the appropriateness of the risk exposure measurement methodology based on the nature, scale and the complexity of the risks with well documented explanations of the approaches and reasonableness of the assumptions. The process of determining qualitative and quantitative risk tolerance limits needs to be described. Setting reasonable risk relationships is expected to be one of the most difficult parts in quantifying the risks. The risk correlations should not be based on historical data alone. Insurers may need to develop a more sophisticated procedure for the forward-looking risk correlation analysis associated with evolving industry conditions, risk positions, the insurer's business strategy, and projection of the business.

Section 3 brings together the qualitative part of enterprise risk management in section 1 and the quantitative measurement of risks from section 2, connecting business strategy and capital planning. For risk management purposes, group risk capital is assessed taking into account multiple dynamic risks; this is different than the regulatory capital that is the minimum capital amount before any regulatory action is taken. Insurers need an adequate amount of capital to be solvent and to achieve the insurer's business objectives for an appropriately long time horizon. For the group risk capital, insurers should present the solvency basis, time horizon, modeled risks, risk quantification methodology, target level of capital, and any benefit from diversification. For the prospective solvency assessment, the insurers will also have to include information on the quality of the capital, current exposure, how adequate capital is allocated to each operation, and the projected business plan, including any management action plan if the capital falls below the target level.

ISSUES WITH THE CURRENT U.S. ORSA DRAFT

Currently the U.S. NAIC ORSA and the EU Solvency II ORSA require a different degree of involvement of management in the ORSA process. During a presentation[4] at the Groupe Consultatif Summer School in May 2011, EIOPA Chairperson Gabriel Bernardino noted that ORSA changes the viewing angle from bottom-up to top-down and that ORSA will change the way boards of directors approach the risk and capital management processes. The current U.S. NAIC ORSA guidance manual draft does not consistently distinguish the role and responsibilities of board of directors and senior management for the holistic enterprise risk management processes.

While ORSA assesses the company's risk management process, at the end of the day insurers will have to show supervisors that they comply with the ORSA process requirements properly and that they have adequate capital. Currently in Solvency II, the ORSA guidance requests annual reporting. For the U.S. NAIC ORSA, the reporting frequency is not explicitly established yet. In the introduction of the NAIC ORSA guidance manual draft, it says that "…an insurer who is subject to the ORSA requirement will be expected to regularly conduct an ORSA to assess the adequacy of its risk management and current, and likely future, solvency position, internally document the process and results, and provide a high-level summary report annually to the domiciliary regulator, if requested. Whether an applicable state insurance regulator chooses to request the confidential filing each year may depend on a myriad of factors, such as the nature and complexity, financial position, and/or prioritization of the insurer/group, as well as the economic environment considerations." Reporting frequency was one of the topics discussed in the recent discussion of the August 2011 NAIC ORSA draft. Some suggest that regulators request only an initial ORSA submission with updates when there are any significant changes, while others recommend more regular ORSA submissions. In EU Solvency II, an ORSA report is required at least on an annual basis, but more frequently if there are any changes in the business of the insurer such as mergers and acquisitions. In addition to the ORSA reporting frequency, insurers suggest a consolidated reporting structure so that each group ORSA is submitted to the leading supervisor and reviewed once instead of multiple submissions to individual regulators followed by multiple repetitive reviews and questions.

For the group risk capital assessment, some companies expressed a caution in how the capital will be assessed for the foreign insurers. The companies appealed for the NAIC to set the group capital on a compatible basis for U.S. domestic insurers, U.S. insurers with subsidiaries abroad, and U.S. subsidiary insurers with foreign parents.

One of the major concerns of U.S. insurers is confidentiality. While some companies support the ORSA, others are very opposed to it out of concern that the ORSA will require the disclosure of material management and financial information into a public forum. Solvency II may raise expectations regarding transparency.

Another issue raised was whether the NAIC ORSA guideline is meant solely for insurers or whether it provides views for examiners. Proponents argue that by including more of the examiner's evaluation viewpoint, the guidance manual would be more useful to insurers and be a helpful reference for examiners. Others note that examiners have their own evaluation manual and reference documents, so it would be redundant to include examiners' views in the insurers' guideline.

While the NAIC will continue to use risk-based capital (RBC) as the minimum required regulatory capital, insurer's risk capital assessment will be required by ORSA.

CAPITAL MANAGEMENT UNDER ORSA

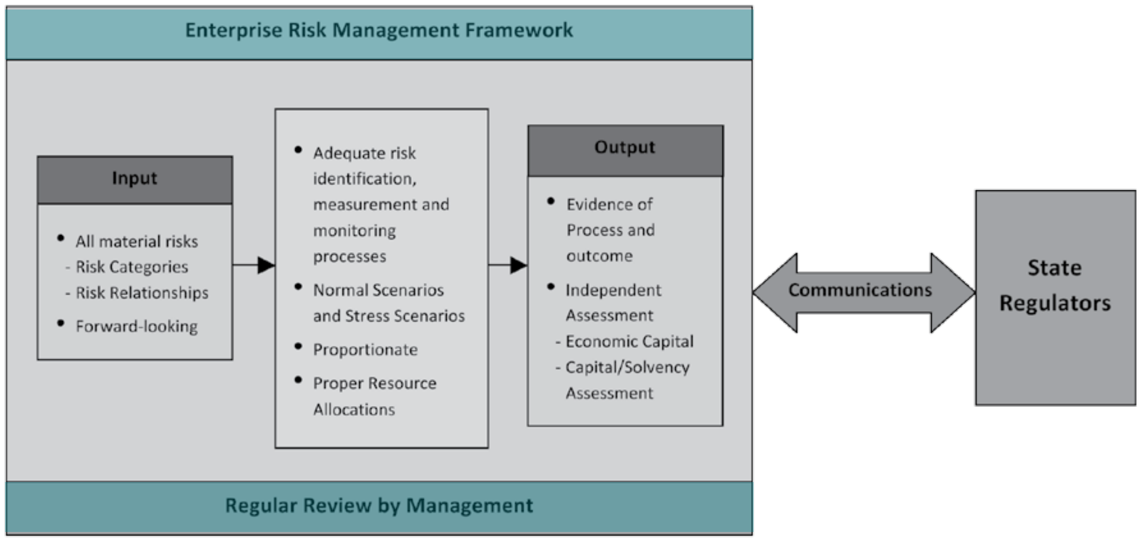
While the NAIC will continue to use risk-based capital (RBC) as the minimum required regulatory capital, insurer's risk capital assessment will be required by ORSA. For this capital assessment purpose, the NAIC focuses on group economic capital, determined based on the nature, scale, and complexity of the risks within the group. For the group capital assessment, either the consolidated or aggregated approach can be selected as long as each legal entity or affiliated insurer under the same group utilizes a consistent methodology.

The NAIC ORSA guideline needs to consistently declare that it is the economic capital that the insurance holding company (group) will assess. Regulatory RBC capital has to be clearly distinguished from economic capital that will be examined under ORSA.

STATES' OUTLOOK OF ORSA

States are expected to take actions in line with the NAIC's ORSA development progress. Some states could initiate a movement tied to ORSA before the ORSA model law is developed by NAIC. For example, New York recently issued a proposed circular letter[5] that encourages insurers to maintain a formal ERM function to "identify, measure, aggregate, and manage risk exposures within predetermined tolerance levels, across all activities of the insurer or group of insurers." According to the letter, New York has developed evaluation criteria to assess insurers' ERM practices. ORSA is mentioned in the brief descriptions of the evaluation criteria. The letter states that "the insurer should perform an ORSA on a regular basis and should share the results of the assessment with senior management and its board of directors" and "an insurer

CONTINUED ON PAGE 20



should address as part of its ERM/ORSA all reasonably foreseeable and relevant material risks including, at a minimum: insurance; underwriting; asset-liability matching; credit; market; operational; reputational; liquidity; and any other significant risks associated with group membership."

INSURER'S CONSIDERATIONS FOR ORSA

To respond to all the ORSA requirements from the NAIC and state insurance departments, insurers will consider:

- Gap analysis—current ERM framework and process vs. ORSA requirements;
- Clearly defined risk management strategy and action plan;
- Stress test scenarios/assumptions review and documentation;
- Risk measurement and approach analysis and documentation;
- Model assumption maintenance and documentation;
- Risk appetite and risk tolerance linked to business operation;
- Capital allocation methodology and its interaction with business risk management; and
- Changes to reporting processes.

ORSA is an evolving and dynamic process. When the ORSA guideline is adopted, it will reflect feedback from industry, guidelines from other jurisdictions, and new IAIS principles. It will evolve continuously over several years.

Insurers should begin considering what information would need to be included in an ORSA, whether their information and reporting systems can provide the information, and whether the company's resources are sufficient for the task. An ORSA requirement of some form is likely and companies should be learning about what may be required and what needs to be done to satisfy it. ■

END NOTES

1. *http://www.naic.org/documents/committees_ex_isftf_smi_roadmap_110520.pdf*
2. *http://www.naic.org/documents/committees_ex_isftf_smi_overview.pdf*
3. *http://www.fsa.gov.uk/pages/About/What/International/pdf/solvency_2_educational_briefing.pdf*
4. *https://eiopa.europa.eu/fileadmin/tx_dam/files/aboutceiops/Summer-School-ORSA-The-heart-of-SolvencyII.pdf*
5. *http://www.ins.state.ny.us/circltr/propose/ERM_Circular_Letter.pdf*