Article from:

The Financial Reporter

September 2012 – Issue 90

An ORSA Summary Report and ORSA Model Act Update

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The National Association of Insurance Commissioners (NAIC) is forging ahead with development of the Own Risk and Solvency Assessment (ORSA), which will bring major changes in the way U.S. insurers conduct and report risk management. The ORSA Guidance Manual, adopted at NAIC's spring 2012 meeting, and draft ORSA Model Act provide the purpose, scope, and requirements for the initiative to improve insurance companies' ability to manage risk.

The commissioners hope that the final ORSA Model Act will be ready for implementation by state governments by Jan. 1, 2015.

Under the new rules, all insurers and their insurance "groups" over a certain size must conduct the ORSA. Regulators want insurers to implement risk management governance into all key areas of their operations, and to integrate their risk and capital control processes effectively. The rules also demand improved reporting to provide senior management with a better understanding of the risk profile in key areas.

ORSA GUIDANCE MANUAL

The ORSA Guidance Manual provides the purpose of the ORSA and guidelines for insurers to develop the ORSA Summary Report, outlining a comprehensive risk management framework that will enable insurers to:

- Manage risks and capital with forward-looking perspectives;
- Implement risk management and control processes appropriate for the insurer's business nature, objectives and complexity;
- Integrate risk management with capital actions to support the business strategy and planning; and
- Coordinate company-level risk management with group-level considerations.

The ORSA process encourages insurers to develop continuous, forward-looking assessments of company- and group-level risks, as well as an assessment of potential risks the insurer can face based on the insurer's business plan under either normal or stress scenarios. It can also link the insurer's risk assessment and capital views to the insurer's and the insurance group's financial solvency.

Comprehensive documentation of the risk management framework, processes, and governance is a necessary element of ORSA.

The ORSA Guidance Manual directs that the ORSA Summary Report include, at a minimum, the following three components:

- 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.

In addition to the ORSA Summary Report, insurers should maintain more in-depth risk management documentation and backup materials that support the submission to the commissioner. The regulator may request additional information to examine the insurer's risk management processes in detail. It is not clear yet if the ORSA Summary Report submission and review process will be coordinated so that the report need be filed only with the lead state regulator. Otherwise, the report filing and subsequent dialogue between the insurer and regulators could become unmanageable.

Section 1 – Description of the insurer's Risk Management Framework

According to the ORSA Guidance Manual, Section 1 of the ORSA Summary Report should address the following topics in the risk management framework:

- Risk Culture and Governance;
- Risk Identification and Prioritization;
- Risk Appetite, Tolerance, and Limits;
- Risk Management and Controls; and
- Risk Reporting and Communication.

This information can provide a better understanding of the insurer's overall risk management culture and the integration of risk management within the business operations. Still, insurers should have the group/company risk management policies and procedures in place because regulators can ask for supplementary materials. Regulators will evaluate the suitability of the key principles based on the particular insurer's risks.

Section 2 – Insurer's Assessment of Risk Exposure
Section 2 of the ORSA Summary Report should describe the insurer's primary risk assessment in both normal and stressed environments. The material risks that were identified and categorized in Section 1 are measured using either quantitative or qualitative methods. The risks should be quantified in a manner consistent with how business is managed on a group, legal entity, or other level. The ORSA Guidance Manual suggests including the likelihood and impact on financial statements and cash flows when measuring the risks. It also suggests assessing the stress impact on risk capital and available capital. The insurers should show the model validation including the factors considered and model calibration involved in the risk assessment. Due to the uniqueness of each insurer's risk profile, regulators won't provide a standard set of stress scenarios to test the risk exposure of the insurers. However, regulators may provide as inputs a set of stress factors for insurers to apply in the stress testing. These inputs into the risk assessment and capital model may create additional administrative burdens for insurers.

Section 3 – Group Risk Capital and Prospective Solvency Assessment
Section 3 links risk assessment functions to the insurer's business and capital management. The manual requests that insurers integrate capital management with their business strategy and decision-making process over longer time horizons, between two and five years. This capital adequacy test is not only based on the projection of the current business plan. A prospective solvency assessment must be coordinated with any relevant internal and external changes in both normal and stressed circumstances. In other words, this forecasting process will be part of the insurance operation decision-making process in the event that any additional business action is required under a stressed environment, any business plan has to be modified based on different environments, or where there are any capital adequacy concerns.

The ORSA Guidance Manual allows flexibility in the capital adequacy testing approach, as it does not specify any accounting basis or projection horizon. Insurers can select the appropriate projection horizon and the most suitable risk capital reflecting the company's risk culture, objective and decision-making process. However, although ORSA respects flexible approaches based on each company's different risk profile and business objectives, the ORSA Summary Report should include a description of the approach including key methodologies and assumptions used in capital analysis. The examples provided in the manual are:

- Definition of Solvency;
- Accounting or Valuation Regime;
- Business Included;
- Time Horizon;
- Risks Modeled;
- Quantification Method;
- Risk Capital Metric;
- Defined Security Standard; and
- Aggregation and Diversification.

NAIC ORSA (E) SUBGROUP UNDER FINANCIAL CONDITION (E) COMMITTEE

The ORSA (E) Subgroup, created under NAIC's Financial Condition (E) Committee, is responsible for issues related to ORSA implementation, including[1]:

- Creating an ORSA Feedback Pilot Project in 2012 for five to 10 undisclosed groups to voluntarily submit an ORSA Summary Report for regulatory review under a confidentiality agreement, in order for regulators to be able to provide some high-level feedback to the industry prior to the actual report's effective date.

- Developing an ERM education program where regulators will benefit from additional guidance and/or training.

- Developing a glossary to include in the ORSA Guidance Manual to provide clarification on terminology.

- Studying the need for the NAIC to hire an ERM expert to provide staff support and future mainte-

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nance of the guidance on ERM and ORSA, and to provide assistance and training to states as they begin the examination and analysis.

Twelve insurers initially volunteered to participate in the ORSA Feedback Pilot Project. The insurers, who remain confidential, were expected to submit a full or partial mock ORSA Summary Report. The Pilot Project is intended to show how the ORSA Guidance Manual is understood by insurers and to identify which areas need more clarification. The analysis of the reports will influence the next version of the manual. International insurance organizations have also expressed interest in the result of the pilot project.

OWN RISK AND SOLVENCY ASSESSMENT MODEL ACT

The Group Solvency (E) Issues Working Group initially considered the NAIC's Insurance Holding Company System Regulatory Regulation Form B as the reporting vehicle for the ORSA Guidance Manual. However, the industry expressed concerns, particularly on confidentiality issues, because some states considered the Form B public information. Instead, the group agreed to draft an ORSA Model Act and expose it for comment. During the NAIC Spring Meeting, the request to create an ORSA Model Act was formally adopted.

An initial draft of the ORSA Model Act is currently being discussed by working group members and interested parties. In accordance with the fact that an "Enterprise Risk Management (ERM) Framework" is requested in section 1 of the ORSA Summary Report, maintaining an ERM framework was added to the draft. It is now the *Risk Management* and Own Risk Solvency Assessment Model Act. Consequently, a section was added for the requirement of the maintenance of a risk management framework.

> During the NAIC Spring Meeting, the request to create an ORSA Model Act was formally adopted.

According to the draft, insurers shall conduct ORSA regularly, no less than annually, and at any time when there are significant changes. The ORSA Summary Report will be submitted to the commissioner on an annual basis.

The NAIC working group respects the flexibility of ORSA and will try to allow an adequate level of discretion in determining terminologies, directing ORSA Summary Report contents, and guiding ORSA processes.

One of the main concerns from the industry is confidentiality protection. The ORSA Summary Report and supplemental information include insurers' essential strategies developed internally, which may be highly confidential. Within the industry, there are concerns that the commissioner may share such confidential documents with other state, federal and international regulatory agencies or law enforcement authorities, with the NAIC or with third-party consultants. The Model Act draft was amended so that report recipients agree in writing to maintain confidentiality, and verify in writing the legal obligation to maintain confidentiality. The Act also extended the information-sharing provision to more than necessary regulatory entities, which can lead to insurers' reluctance to disclose highly confidential risk management information. Some of the information sharing entities listed on the current Model Act draft are not clearly identified or necessarily relevant to regulations.

The draft of the Model Act did not specify the timing of the ORSA Summary Report submission to the commissioner. Though the draft gave insurers flexibility given each insurer's different schedule for strategic and capital planning processes, the industry commented that in practice insurers need a specific due date in order to coordinate internal ERM processes with reporting and filing requirements. When multiple states request reports without specific due dates, it could be particularly difficult for insurers. After several discussions about setting a specific filing date for the ORSA Summary Report (June 30th or September 30th were primarily discussed) to respect insurers' different strategic planning schedules, the current Act draft does not have a specific ORSA Summary

Report filing date. Instead, the Act requests that each insurer decide its filing date with its commissioner.

The effective date of the ORSA Model Act has moved to Jan. 1, 2015. The originally proposed effective date of Jan. 1, 2014 brought some concerns, since some states might not be ready to implement ORSA. This also means that they should have an appropriate risk management framework and establish a process for the ORSA Summary Report before the Act effective date. The new effective date of Jan. 1, 2015 can provide states time to pass the ORSA law and have experts to understand and review the reports.

ORSA IMPLEMENTATION

With adoption of the Guidance Manual and the development of the ORSA Model Act under way, insurers need to evaluate potential gaps based on the current guidance and take steps to address them. The more proactive insurers are developing mock ORSA Summary Reports to identify those gaps and to develop an efficient process for their ORSA Summary Report. Insurers need to make sure that they have a group-level risk profile that is regularly monitored with corresponding capital management strategies. Capital should be managed with a long-term perspective with appropriate projections of the insurer's business.

In implementing the ORSA process and developing the contents of the ORSA Summary Report, engaging the following areas is important:

- Actuarial: Developing actuarial models, maintaining and updating assumptions, performing calculations and long-term projections.
- Risk Management: Assisting with the development of the ERM framework, risk appetite, risk tolerance, and risk limits. Analyzing the risk profile of the insurer, and cooperating with all the other areas to oversee the risk management processes and controls.
- Underwriting: Having ownership in underwriting risk management and providing underwriting risk input.
- Internal Audit: Providing an independent oversight of the ORSA process.
- Information Technology: Enhancing systems to efficiently produce accurate information. Assisting in the development and filing of the ORSA Summary Report.
- Compliance: Providing a mechanism to identify changing regulations and evolving ORSA guidance. Managing ORSA compliance risks.
- Finance: Producing financial reports. Incorporating projections of the future capital management information within the business plan. Coordinating with other areas to consolidate financial data.
- Investments: Providing investment data and projections and managing ALM under both normal and stress conditions.

The ORSA is more than a pro forma, compliance exercise. It will strengthen insurers' forward-looking risk management, while linking capital management and risk management more closely. Insurers should be able to disclose whether their capital projections can meet the regulatory requirements under both normal and stress conditions. Insurers should understand the risks that can most significantly impact capital. They need to have dynamic risk monitoring procedures that include robust risk profile reporting to senior management. Insurers will find value in developing an early understanding of ORSA's requirements and an action plan for implementation. ■

REFERENCE

NAIC Spring 2012 National Meeting Executive (E) Meeting Summary Report *(http://www.naic.org/meetings1203/summary_ex_cmte.htm)*

NAIC Solvency Modernization Initiative Roadmap (March 29, 2012)

END NOTES

[1] NAIC Committees & Activities; Own Risk and Solvency Assessment (ORSA) (E) Subgroup, Financial Condition (E) Committee (*http://www.naic.org/committees_e_orsa_wg.htm).*