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ORSA Readiness: The Time Is Now

INSURERS THAT SEE BEYOND SEEMINGLY SIMPLE BASELINE REQUIREMENTS CAN LEVERAGE ORSA COMPLIANCE TO BOLSTER ERM CAPABILITIES

By Bill Spinard, Chad Runchey and James Collingwood

After several years of planning and industry input, the Own Risk and Solvency Assessment (ORSA) requirement will soon become a reality for insurers. Many jurisdictions—including the United States, Canada, the European Union and Bermuda—will require companies to maintain an ORSA process and provide periodic summary reports as part of their solvency regulatory regimes. With broad consensus about the requirements and agreement that the final regulations will be in place by 2015, the time has come for insurers to actively plan their compliance strategies and define how ORSA can boost existing enterprise risk management (ERM) practices.

The introduction of ORSA in the United States represents a significant milestone in the modernization of the regulatory supervisory framework for insurers. Further, it is evidence of the increasing convergence of international regulations around common principles and standards. The U.S. ORSA requires insurers to provide assessments of their capabilities in three specific areas:

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1. Risk management framework,
2. Quantitative measurements of risk exposure in normal and stressed conditions, and
3. Group risk capital and prospective solvency assessment.

Today, with clarity about the basic requirements, there is a seemingly clearer path to near-term compliance. Insurers that have long been uncertain about what ORSA will mean to them—both strategically and practically—must begin weighing the impacts on specific processes, functions and teams across the enterprise.

While it is tempting to focus on the best process for achieving compliance and completing the report, forward-looking insurers are placing more emphasis on the strategic opportunity ORSA presents; that is, they recognize that the quality of an ORSA report is bounded by the quality of an insurer’s ERM framework and, as such, are looking for ways ORSA compliance efforts can generate ERM improvements and additional business value. The key variables in the ORSA value proposition include:

- Better use of risk capacity for new and existing businesses while remaining within stated risk appetites.
- Improved risk-based decision-making through a single framework for risk, capital and performance management.
- Increased understanding of risk exposures across the enterprise.
- Promotion of a risk management culture and greater visibility for risk on the senior management and board agendas.
- Deeper insights into the solvency impacts of future economic conditions.
- Clearer visibility into capital tiers supporting risk-taking activity and optimization of capital structures.

The bottom line is that ORSA readiness represents an excellent opportunity for insurers to bolster their overall risk management capabilities—provided they look beyond a strictly compliance-driven, “check the box” attitude and align their readiness efforts to longer-term risk management needs.

CORE CONCEPTS FOR INITIAL ORSA ACTION

Before building the ORSA implementation work plan, organizations must understand a number of core concepts that will help drive substantial returns on ORSA efforts and investments:

- **ORSA should not be underestimated.** The baseline ORSA requirements, what might be called “the letter of the law,” are deceptively simple. The Guidance Manual itself is about 10 pages, with questions and information requirements that are somewhat vague and generalized. It will be tempting, then, for carriers to simply develop a summary report that “checks the boxes.” However, insurers taking such a stance will miss the opportunity to fundamentally strengthen their ERM capabilities in a number of key areas.
- **Future requirements are likely to be more complex and robust.** There is ample reason to believe that

future ORSA requirements will be more robust, complex and prescriptive. Thus, aiming to meet minimum requirements today may ultimately lead to higher compliance costs in the long run; this is another reason for organizations to adopt a forward-looking view now.

• ***ERM assessments are the right first step for ORSA.***

Conventional wisdom holds that insurers with active ERM programs in place need not worry about ORSA; this is a dangerous assumption. ORSA can become a critical part of the ERM toolkit (especially as it relates to solvency measures), if risk managers and compliance teams can make it meaningful to management across the business. That is a big “if” for many companies. Because the quality of an ORSA report is bounded by (but not equal to) the quality of an insurer’s ERM framework, an important first step relative to ORSA is a full ERM assessment, which will help clarify organizational readiness for ORSA.

By acknowledging these realities, insurers will lay a foundation for both efficient and effective compliance processes and, more importantly, chart a course to stronger ERM capabilities in the long term. The latter point represents the most significant value creation opportunity for insurers as they approach ORSA.

ORSA SHOULD NOT BE UNDERESTIMATED

The ORSA Guidance Manual is a relatively quick read, and the key components are summarized within the first few pages of the document. But this deceptive simplicity masks a number of important subtleties and nuances across a number of critical risk areas. Collectively, these factors make ORSA compliance, both in the short and long terms, a trickier proposition.

For example, the Guidance Manual explicitly references to the International Association of Insurance Supervisor’s Insurance Core Principle 16 on ERM, which contains additional details that the Guidance Manual does not directly address. While it is not clear that insurers will be required to meet all of the guidance in the core principles document, it is clear that the spirit

of the ORSA summary report is intended to be consistent with the contents of this principle.

There are a range of other areas with similar “gray areas” within the Guidance Manual, where there are significant gaps between minimal initial compliance standards and bigger-picture opportunities relative to ERM. Those areas include risk appetite, risk measurement, future capital requirements and group risk and capital assessment.

Risk appetite: A risk appetite statement can be a very powerful tool to manage overall risk exposure; however, if poorly defined, it can appear to be a meaningless qualitative statement unrelated to day-to-day operations or decision-making. The concept is simple: have executive leadership, including the board, clearly state how much risk they are willing to take. That overall risk appetite can then be cascaded down through the business in order to ensure that risk exposure is always within the stated appetite and that formalized processes are in place to deal with exceptions. While such an approach to defining and operationalizing risk appetite is uncommon in the industry today, a meaningful risk appetite statement that has been approved by the highest levels of management is an enabler of effective ERM frameworks.

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Risk measurement: Another critical component of understanding risk is the ability to quantify exposure to key risk types. Consistency is important when trying to compare risks between different risk types (e.g., market to catastrophe), product lines (e.g., life insurance to homeowners to health insurance) and jurisdictions (e.g., Japan to the United States). While there are many approaches for quantifying risk, an approach that

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allows for consistency is critical to providing management with a full picture of risk exposure.

Future capital requirements: Typically, risk exposure and capital calculations are performed as of a specific point in time. While this is a valuable piece of information, the ORSA process requires the projection of future capital requirements over the next one to three years (taking into account the business plan of the organization). By incorporating the specific products and markets in which a company is looking to grow, a prospective look at capital can provide management with critical information as to what the capital requirements may be in the future. Incorporating stress testing can give management a clearer picture of potential issues related to their business plans.

For some product lines and balances, projecting risk capital may seem fairly straightforward (e.g., projecting NAIC RBC requirements for lines that do not require principles-based calculations). However, for any economic capital measurement or products that require a stochastic analysis to measure RBC, the projection of future capital requirements is very complex. Thus, it is important to think through potential approaches to simplify calculations while retaining the direction and magnitude of actual results.

Group risk and capital assessment: For large insurance groups, consistent views of risk and capital across various legal entities are difficult to achieve. Pulling together a consolidated view often requires mixing and matching accounting and capital regimes, product lines, currencies and other complicating factors, including the ability to use capital from one entity for another.

These important issues are all implicitly raised by the ORSA Guidance Manual, suggesting the hidden depth and complexity in that brief document and likely pointing the way forward for future evolution of the standards. To be clear, initial ORSA compliance efforts may not yield complete maturity along all of these critical ERM dimensions. However, they can certainly enable progress by sparking important conversations among business stakeholders, senior executives and risk management teams.

FUTURE REQUIREMENTS ARE LIKELY TO BE MORE COMPLEX AND ROBUST

Today, ORSA requirements are brief, principles-based and give companies wide discretion. However, experience with previous guidance confirms that in the future, ORSA requirements are likely to be increasingly complex, robust and prescriptive.

Consider how the current NAIC ORSA Guidance Manual does not prescribe a standardized reporting structure and allows for flexibility when calculating capital requirements. This means that the sections relevant to forecasting capital may prove especially tricky in that insurers with very limited capabilities in this area may describe a process that sounds more mature. Also, ORSA has made clear that the length, depth and granularity of information provided depend on the nature, scale and complexity of insurer. The bottom line is that insurers will find plenty of room for interpreting the requirements.

Companies will have to determine how to navigate through the general, principles-based structure of the Guidance Manual. This may seem minor in terms of initial compliance, but is almost certain to lead to greater complexity and higher compliance standards in the future.

Moving into initial compliance efforts, insurers must understand how and where ORSA introduces new concepts and nuances and how those might evolve in the future. For instance, the time horizon used for business planning—generally one to three years—can change depending upon the insurer and which risks are being

modeled. Areas like “management actions” and “stress and scenario tests” are also open to broad interpretations, which can result in wide variability in the reports.

Given the past experience of regulatory oversight in financial services, ORSA is highly likely to become a fundamental risk reporting metric in the future. Both risk-based capital (RBC) regulation in insurance and the Basel guidelines for banks provide a template for ORSA’s future evolution. It will almost certainly become more robust, with more specific, detailed and comprehensive reporting requirements, and an annual updating process with periodic milestones available to measure progress.

ERM ASSESSMENTS ARE THE BEST FIRST STEP

The connection points between ERM frameworks and the ORSA process are numerous and direct. In fact, the requirements outlined in the NAIC ORSA Manual can be aligned to overarching ERM framework components. For instance, ORSA summary reports will document the existing ERM framework and its outputs. ORSA Section 1 seeks information about overall governance arrangements and risk appetites, as well as risk monitoring, policies and internal controls. Other sections focus on risk reporting, management information, and decision and planning support. Similarly, ORSA reports emphasize risk assessment and measurement—critical components of any ERM framework.

This is not to say that ERM frameworks are by themselves sufficient for ORSA compliance. Rather, ORSA assessments can help insurers evaluate their current ERM capabilities, identify gaps and prioritize improvement plans. For instance, ORSA can help insurers address such common organizational challenges as unclear or fragmented committee structures and lack of board engagement. Similarly, the ORSA process can help clarify risk identification, risk categorization and control, as well as risk-reporting issues, including data quality.

In addition, insurers that use the ORSA requirements to enhance their ERM programs may discover valuable insights, including: risk-adjusted measures for product

pricing, improved metrics to identify underperforming businesses, ability to evaluate multiple risk mitigation strategies and more consistent risk-taking decisions to list a few.

Achieving an efficient path toward near-term ORSA compliance and strengthening overall ERM practices are not mutually exclusive goals. In fact, driving simultaneously on both of these fronts will enable insurers to realize several benefits at once. A more efficient compliance process can certainly result in cost savings associated with the automation of manual tasks and reduction of duplicative efforts. An efficient compliance process should be built on insights about current data feeds and information assets that can be used for ORSA compliance and a clear understanding of the resources necessary for compliance.

Further, it can provide insights into future requirements based on more engagement with regulators as standards are finalized. But, here again, insurers must take a broader holistic view, as opposed to simply seeing the “path of least resistance” to compliance.

Looking at longer-term ERM capabilities, ORSA provides clear justification for insurers to take a closer look at current structures and practices and identify gaps and opportunities for improvement. In this sense it is a unique opportunity to drive maturity into ERM models and help position risk management programs and teams for future evolution.

ASSESSING ORGANIZATIONAL READINESS

It can be argued that the NAIC ORSA Guidance Manual is laid out at a high level because the industry has made the point that most of the components of a good ERM framework are currently in place and therefore compliance will not create additional work. Clearly, some ERM leaders have the ability to develop a quality ORSA summary report. However, it is just as clear that many carriers do not have the ability. There is a wide range of ERM maturity and practices across the industry, varying significantly based on lines of business and the size and strength of the insurer.



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Thus, the question becomes how insurers can assess their own readiness for ORSA. Key questions carriers should ask are:

1. Does the company understand the requirements as stated by the ORSA Guidance Manual and the key components of ICP 16 on ERM?
2. Is a documented risk appetite statement used to inform business decision-making?
3. Is exposure for all types of risks measured in a consistent way?
4. Can the company project future risk capital requirements consistent with short-term business plans?
5. Is it possible to create a group risk and capital assessment with a consistent measurement framework?

Organizations that answer “yes” to all of these questions are on the right track to deliver quality ORSA summary reports. Organizations answering “no” to any of these

questions can take some comfort in knowing that there is time to enhance their capabilities prior to ORSA’s effective date. Some of the items on the list above are straightforward and manageable. Others, however, can be complex and require significant planning and resources to implement. However, once implemented, capabilities like risk appetite, consistent-risk quantification, projection of capital and group risk and capital assessments are extremely valuable tools for effective ERM programs and for providing management a much clearer picture of companywide risk exposure.

CONCLUSION

ORSA introduces new risk disclosures into the insurance regulatory environment. Regardless of the present challenges that exist to comply with ORSA, there is a great opportunity for insurers to develop sound risk management processes that serve as the basis for sound business practices. The keys are to avoid underestimating ORSA requirements, develop solutions that go beyond superficial compliance and seize the opportunity to strengthen existing ERM practices and overall risk management functions. ■

The views expressed herein are those of the authors and do not necessarily reflect the views of EY.