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Understanding ORSA: Risk, Solvency and Beyond

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In August 2012, the National Association of Insurance Commissioners (NAIC) approved the Risk Management and Own Risk and Solvency Assessment (RMORSA) Model Act and state legislatures are in the process of adopting it. Is your company ready to demonstrate to regulators how the overall enterprise risk management framework is maintained? Does your company have a risk appetite aligned with the risk strategy set forth by the board of directors? Will your C-suite be able to demonstrate how your capital level is tied to the business plan? These are some of the Own Risk and Solvency Assessment (ORSA) questions that go beyond the current risk-based capital requirements. Starting in 2015, all insurers meeting the minimum premium threshold must comply with ORSA requirements.

The NAIC RMORSA Model Act will have a lasting impact on the insurance industry. A product of the NAIC's Solvency Modernization Initiative, ORSA is a capital and enterprise risk management (ERM) requirement. Similar to the current risk-based capital (RBC) requirements, ORSA requires an insurer to demonstrate capital adequacy. But unlike RBC, ORSA is designed to be a customized, forward-looking and, in many ways, more holistic solvency system.

What Is ORSA?

All individual insurers writing at least $500 million in direct written and nonaffiliate assumed premium are subject to ORSA requirements effective Jan. 1, 2015. To prevent their subsidiaries from taking on excessive risk, insurance groups writing at least $1 billion in direct written and nonaffiliate assumed premium are also subject to ORSA. Under the RMORSA Model Act, insurers are required to conduct an internal assessment and file the results in a confidential ORSA summary report to the lead state regulator once a year.

The ORSA summary report is divided into three sections to address different aspects of an insurer's risk management capabilities: minimum risk management framework, internal assessment of risk exposures, and assessment of group risk capital and prospective solvency.

Section 1 concerns the insurer's ERM framework. The insurer must demonstrate evidence of risk culture and governance, processes of identifying and prioritizing risks, a formal risk appetite statement, risk management procedures and a reporting mechanism that monitors risks. The insurer must show how risks are managed and how they are integrated into the business strategy. Section 1 should also identify the tools that actively assess changes in the insurer's risk profile and mitigation procedures in place.

Section 2 concerns the insurer's qualitative and quantitative assessment of its risk exposure. In this section, the insurer must detail the methodology, key assumptions and outcomes from its risk exposure assessment. The NAIC states that the assessment should be carried out with techniques appropriate to the insurer's "nature, scale and complexity." This means ORSA must be conducted in a manner consistent with how the business is managed and also meet what is informally known as a "use test." To pass the ORSA use test, the insurer must demonstrate that the previously mentioned risk assessment serves as an integral part of management's business planning process. The risk embedded in a business plan needs to be addressed and the actuarial team must engage management to tackle difficult questions. For instance:

- What is the most effective approach to assess the insurer's underwriting (or operational, credit, etc.) risks?
- What constitutes a normal business environment? How are stress scenarios defined?
- How does available capital fluctuate over the defined timeframe?
- Is the correlation relationship between different risk categories appropriate? Should the relationship be static or does it change under stress scenarios?

The risk measurement aspect of ORSA may not be as prescribed as requirements such as RBC or the European Union's Solvency II Directive. The NAIC's intention is to allow insurers the freedom to reflect the unique nature of their risk profiles, not give them an excuse to choose the easiest approach. As opposed to a checkbox exercise, ORSA dictates that an insurer's results must be consistent with its

business plan. Insurers who do not take ORSA seriously will likely fail the use test.

Section 3 concerns the manner in which an insurer's capital resources are tied to the qualitative and quantitative assessment of its risk profile over the long run. The purpose of Section 3 is to "assist the commissioner in assessing the quality of the insurer's risk and capital management." The idea is that insurers who take on more risk should hold more capital.

In this section, the insurer must carry out two forms of assessment: a group assessment of risk capital and then an assessment of prospective solvency. Risk capital concerns the level of financial resources required to underwrite risks, whereas solvency is the insurer's ability to meet its obligation in a manner consistent with its risk appetite. The NAIC provided a list of considerations insurers should address in determining their capital adequacy at the group level.

- The relevant and material risk types to be included in the measurement of risk capital
- The definition of solvency in terms of risk capital and liquidity (e.g., threshold defined at x percent of annual premium)
- The accounting or valuation basis for the measurement of risk capital (e.g., generally accepted accounting principles [GAAP], statutory)
- The business segments to be included
- The time horizon to model and measure risks
- The methodology to quantify risk exposure (e.g., deterministic stress testing, stochastic modeling)
- The metrics to be used in measuring the level of aggregate risk capital

As for the assessment of an insurer's prospective solvency, the NAIC mandates insurers have "a robust capital forecasting capability that supports its management of risk." The assessment of solvency should be carried out in conjunction with an insurer's business planning process. Unlike the current RBC framework, ORSA is measured on a going-concern basis. Long-term business plans developed by management must be accompanied by an adequate level of capital that supports all inherent risk types.

Potential Improvements

The main objectives behind the NAIC's Solvency Modernization Initiatives (SMI) is to improve the existing solvency requirements in the United States by examining elements of other regulatory frameworks around the world. The ORSA framework, the product of NAIC's SMI, has three improvements over the current RBC requirements.

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With ORSA's holistic view of risk and solvency, health plans can use new ERM tools to truly balance risk and reward.

First, ORSA accounts for all risks material and relevant to an insurance company. The current health RBC formula accounts for only five risks: affiliate asset risk, nonaffiliate asset risk, underwriting risk, credit risk and business risk. The intention was to capture the key risk categories that would ensure the well-being and solvency of the industry as a whole. Where the RBC formula differs is that it was calibrated to the *average* insurer's probability of ruin and cannot account for every permutation of risks for all insurers. For instance, operational risk—a risk category gaining attention in the ERM community—is an area the RBC formula currently does not account for. As a factor-based approach, the static RBC formula cannot account for all risks tied to an insurer's business plan. Unlike RBC, ORSA is tailored to each insurer's risk profile and, therefore, by design, addresses all risks an insurer is exposed to. ORSA allows for a customized approach to assess an insurer's unique capital needs.

Second, ORSA results must be proved reliable and embedded in the insurer's business plan. This is a feature of ORSA that goes beyond capital adequacy. The RBC is a rule-based approach to quantify an insurer's risk profile. In reality, however, there may be a substantial disconnect with what an insurer files for its statutory reporting and what it considers in its business strategy. The use test embedded in ORSA eliminates the ambiguity between the two bases.

Third, ORSA requires a prospective view of an insurer's capital needs. The RBC formula is not carried out on a going-concern basis and is therefore disconnected from the forward-looking nature of business planning. RBC filings do not account for management's view of emerging risks—such as the expiry of the 2Rs or the impact of newly insured young individuals—that often defines an insurer's strategy. Strictly speaking, this aspect of ORSA is not necessarily an improvement over RBC. The two frameworks serve different purposes; RBC is a point-in-time statutory measurement, whereas ORSA examines the insurer's risk profile as an ongoing entity. RBC takes a snapshot of an insurer's capital level and balance sheet at the valuation date. ORSA ensures an insurer's capital adequacy and prudent risk management practice going forward. To continue to underwrite risks, an insurer must demonstrate it is financially stable under both regulatory regimes.

Challenges for Health Plans

Relative to other insurers, health plans are likely to experience additional challenges in the implementation of various ORSA provisions. Due to the nature of their long-tail liability, life insurance carriers typically have much stronger capital and risk modeling capabilities than the average health plan. Additionally, health actuaries cannot simply replicate the ERM functions at life insurance companies for many reasons: People shop for new health coverage much more often than a new life policy, health plans have to deal with the uncertainty of working with providers and networks, claims cost can change significantly from one period to another, and life insurance payouts typically do not have friction costs arising from litigation and complex adjudication processes.

What this means is that there is no off-the-shelf ORSA solution for health plans. Some health plans operate on the national level, whereas others thrive in a single region. Meeting all ORSA requirements will be challenging for health plans, but the upside is that we are starting from scratch and can draw from lessons other practitioners have learned.

An ORSA Game Plan

With 12 months until the requirements are in effect, insurers must start to prepare. ORSA is a game changer and requires a new mindset. Full implementation will likely require a plan to address all key areas.

- **Capital management**
  - -Determine the optimal approach for economic capital calculation and projection
  - -Find the proper balance between feasibility and accuracy
- **ERM framework**
  - -Integrate existing and new risk management processes into one consistent corporate policy
  - -Strengthen ERM governance framework
  - -Establish a meaningful link between the group's and the subsidiaries' risk tolerance

- **Strategy**
  - -Align key aspects of business planning and risk modeling to increase the relevance of ORSA in decision-making processes; buy-in at the C-suite level is important
- **Resources**
  - -Update skillsets of finance, actuarial and risk management practitioners
  - -Develop adequate risk processes, controls and quantification tools
- **Risk culture**
  - -Create broad ownership of the ORSA process to prevent a "silo-based" approach across entities and risk categories, with full staff engagement on all levels
  - -Improve communication between key stakeholders
  - -Manage business in accordance with the defined risk appetite and risk tolerance levels
- **Technology**
  - -Develop robust systems and data environment to analyze risk metrics in a timely manner

ORSA will likely allow the industry to gain a better understanding of the underlying risks. As the effects of the Patient Protection and Affordable Care Act (ACA) are realized in the years to come, ORSA will likely empower insures to examine their own risk profiles and objectively study the benefits of specific strategies, business segments and product offerings. Be it the health plan's financial viability in the exchange market, the long-term claims impact from high-risk individuals or the profitability pressure due to new minimum loss ratio rules, the ACA certainly poses many layers of strategic and operational challenges. With ORSA's holistic view of risk and solvency, health plans can use new ERM tools to truly balance risk and reward. ORSA alone may not be enough for the insurance industry to weather the next economic downturn unscathed, but as we have seen since the 2008 credit crisis, companies with more advanced risk management frameworks tend to be better positioned to withstand unfavorable conditions.

A lot of times we get asked what an actuary does. We all have our little scripted answers. But long story short, we manage risk. And risk is what ORSA is all about.

END NOTES

[i] National Association of Insurance Commissioners (NAIC). "NAIC Own Risk and Solvency Assessment (ORSA) Guidance Manual." March 2012. *http://www.naic.org/documents/committees_e_orsa_wg_related_docs_guidance_manual_2013.pdf.*

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