

HOW TO REVIEW AN ORSA

Co-Sponsoring Organizations:



How to Review an ORSA: Thoughts for a Board Member's Initial Reading

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U.S. insurers are required to annually conduct an Own Risk and Solvency Assessment (ORSA) and to submit an ORSA Summary Report (the "Report") to their lead state regulator beginning in 2015. The ORSA is a self-assessment conducted by an insurer of the material risks associated with the insurer's own business plan and the sufficiency of capital resources to support those risks. The ORSA is a valuable element of an insurer's Enterprise Risk Management (ERM) framework, linking the insurer's risk identification, assessment, monitoring, prioritization, and reporting processes with capital management and strategic planning.

A company's board of directors is addressed twice in the ORSA Guidance Manual. First, the Report is required to be provided to the board of directors (or the appropriate committee of the board). Second, the manual states that an understanding of the risk appetite statement ensures alignment with risk strategy by the board of directors.

A board member of an insurance company will find great interest in his or her company's ORSA. The ORSA aligns well in supporting the board's governance role and the board's role of consulting with management on the strategic and operational direction of the company. Although successful risk management programs have been in existence for many years in most insurance companies, the ORSA will likely provide new information for many insurers in the form of the quantification of risk metrics and a more thorough documentation of the ERM framework. The document also addresses risk from the enterprise perspective, as opposed to a stand-alone legal entity perspective.

As board members read through their first Report, they might be asking themselves the question, "how do I know if this report is right?"

Overview

From a board member's perspective, "right" means the Report

properly identifies the material risks facing the company in pursuit of its business plan, as well as management's responses to these risks. Board members can rely on four sources as they assess these questions:

- Board self-assessment
- Senior management
- Internal Audit's role
- Outside experts

After the Report is submitted, the lead state regulator may present feedback regarding the quality of the report. It is unclear how comprehensive this feedback will be. Since this feedback is provided after the report is submitted, it is not elaborated below.

Board Self-Assessment

The board is in a unique position in that it understands the strategic and operational direction of the company. Senior management has presented business plans and risk reporting to the board. The board has had the opportunity to ask questions, challenge, and critique these reports. The board member should expect the business plan and risk reporting underlying the Report to be consistent with the business plans and risk reporting previously reported to the board by senior management. The board member should also expect the Report to provide an unbiased view of risk, regardless of the impact that view may have on any of the company's various stakeholders.

The board should engage in discussions around two key risk statements found in the Report – the risk appetite and the risk tolerance statements. The NAIC ORSA Guidance Manual defines risk appetite as, "[T]he overall principles that a company follows with respect to risk taking, given its business strategy, financial soundness objectives and capital resources." There is nothing more strategic than understanding the company's appetite for accepting risk.

This appetite fundamentally defines the types of products a company offers, how those products are priced, reserved, and capitalized, and even how the products are distributed and serviced. The board member should assess if the risk appetite as stated in the report aligns with the board member's understanding of the company's business plan and overall strategic direction.

The manual defines risk tolerance as, "The company's qualitative and quantitative boundaries around risk-taking, consistent with its risk appetite." Reading the Report, the board member may read terms reminiscent of a college statistics course. In their simplest form, risk tolerance statements define the amount of capital (or earnings, or other balance) the company is willing to risk losing based on a given likelihood of that loss occurring.

The likelihood of loss can be defined in terms of very remote events, such as events occurring once every two-hundred years. Thinking about losses in these terms is challenging, even for experts. One aspect of the ORSA somewhat simplifies this. The period for which these types of events need to be defined is over a "longer term business cycle (e.g., the next one to three years)." Thus, the assessment of risk is focused on what might occur over a limited horizon, rather than what might occur over a longer period of time.

The likelihood of remote events occurring is typically based on historical data. The board member should seek to understand why senior management believes the future will behave similar to the past. Black swan events should be considered, particularly in extremely remote event scenarios. The board member could also engage the Chief Risk Officer (CRO) in understanding the stated risk tolerances relative to events that have actually occurred, such as the company's losses from 9/11, the Great Recession of 2008 – 2009, or other macro-economic events.

Senior Management

The board can engage various audiences when assessing the quality of the Report – the Chief Executive Officer (CEO), the CRO, the Chief Actuary, the Appointed Actuary, and the key risk "owners." Depending on the size of the company, the board may delegate addressing some of these audiences to the CRO or, if applicable, to the company's Enterprise Risk Committee.

The CEO is responsible for establishing the risk-taking culture within the organization. The board should engage the CEO in discussing the Report, particularly on bigger ticket items such as the company's strategic direction and business plan, as well as the risk appetite and risk tolerance statements.

The CRO obviously plays a critical role in preparing the Report. The CRO attests to the best of his or her belief and knowledge that the insurer applies the ERM process described in the Report. The board member should seek to understand the support for the CRO attestation, as well as the CRO's overall assessment of the ERM process.

The Chief Actuary and the Appointed Actuary are also resources available to provide insights on the ORSA. In particular, the Appointed Actuary annually opines that reserves make adequate provision for future cash flows required under contractual obligations under moderately adverse conditions. There is a natural partial overlap of the work conducted by the Appointed Actuary and the CRO.

The CRO is generally not the one responsible for managing the risks of the company. The board could also meet with the owners of the material risks of the company to better understand the various key risk exposures and the processes in place to manage the risks.

Internal Audit

Internal Audit provides its own approach to identifying material risks and ensuring those risks are appropriately managed within the enterprise. The board can leverage Internal Audit in several areas.

In companies where the CRO is not in charge of Internal Audit, the board member can use one as a check and balance for the other, where applicable. It may not be surprising, for example, that the CRO and Internal Auditor have a different prioritization of risks. The board can use this information for further discussions around risk management.

Section 2 and 3 of the Report includes quantification of risks that are based on company models. These models are usually complex by nature. Modeling risk is the risk that a model is not fit for the intended purpose, through its design, its coding, or its use. Internal Audit can help reduce modeling risk and prevent mistakes from occurring by defining and testing controls around the modeling function. Best practice suggests companies have defined governance standards and processes around their models that support the ORSA. This practice assures that models used for ERM purposes are considered “production” models and have the same degree of scrutiny

and controls as models used for other important purposes, such as financial reporting.

Internal Audit can also be used to provide a systematic, disciplined approach to evaluate and assist the CRO to improve the overall effectiveness of the ORSA process.

Outside Experts

It is usually prudent to compare an important work product, like the Report, to an external benchmark for the purpose of establishing “best practices.” However, given that ORSA is a brand new standard and the Report is confidential, there is no public information available for comparison purposes. The NAIC has not made the results of its two pilot programs public.

The standard is truly “principle-based” – quantitative work “should consider a range of outcomes using risk assessment techniques that are appropriate to the nature, scale and complexity of the risks”, as well as “the insurer is permitted discretion to determine how best to communicate its ERM process.” No two companies will have identically formatted reports.

Given the complexity and maturity of the company’s ERM process, an outside peer review of the ORSA and the Report may provide value.



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