JOINT RISK MANAGEMENT SECTION

Canadian Institute of Actuaries
Casualty Actuarial Society
Society of Actuaries

HOW TO REVIEW AN ORSA

Co-Sponsoring Organizations:

Creating a Win-win ORSA Review

By Max J. Rudolph

Enterprise risk management (ERM) can be an exercise in adding value or simply another in a long list of buzz words popular with directors, investors and rating agencies. It may even be seen as a roadblock and interventionist tool by company management. An appropriate balance must be maintained. What is the right mix of constraints versus growth, qualitative versus quantitative analysis, and short-term versus long-term decision making? These are all questions that the successful ERM process must resolve to build firm resilience. For an ORSA review to add value it must be completed in an ERM, rather than a traditional regulatory, context.

ORSA reviewers should ask questions, and expect answers that lead to follow-up questions and engaged discussions. What keeps the risk manager, senior management and the board up at night? Where have conflicts been present? Checklists can be used to start the process, but they are not sufficient. Reviewers should use common sense, with contrarian and skeptical comments encouraged. The ERM Actuarial Standards of Practice (ASOPs 46, 47) recently developed can help structure these reviews.

Company resources are tight, and ERM is viewed by some simply as a cost. When risk culture is embedded in a firm, both top-down and bottom-up, better decisions are made. Unfortunately, many Risk Departments are set up to fail by focusing entirely on constraints, being able to stop a project but not being viewed as a partner who understands how risks aggregate and interact to add strategic value. Reviewers of ORSA submissions should look for this involvement in the strategic process. Done right, the focus is on leading risk indicators and brainstorming between areas. This has added benefits for oversight and succession planning.

Unfortunately, many firms form their risk team primarily with junior technocrats collecting quantitative data rather than business experts and experienced practitioners who can qualitatively question specific practices before they get out of control. The same will be true with reviewers of ORSA filings.

Interactions between areas, transparency and concentration risk should be considered during an ORSA review. Look for the inclusion of a natural skeptic and contrarian who is supported by the CEO. Sometimes looking at a graph of recent trends is incredibly useful.

Incentives must be aligned throughout, based on a firm's board approved risk appetite and tolerance. Risk limits can then be set on a consistent basis. It's not common today, but risk managers should not receive a bonus so are not incented to complete a less diligent search for previously hidden risks. Incentive plans should be reviewed as part of the ORSA process.

Contrarian Thought

The best decisions are made after considering all sides of an issue. Acknowledging multiple viewpoints, and filling management teams and boards with members having broad perspectives, helps to avoid groupthink and yes-men. Staffing a team where everyone is expected to agree with the CEO is short sighted. Senior management should encourage skeptical thinking at all levels of the firm. At an insurer, for example, expertise needs to include knowledge of liabilities, investments, finance and operations. Few individuals can check all these boxes. Internal staff from another division, or external consultants (or rotating consultants), can bring different backgrounds and perspectives. It is often easier for an outsider to make waves than for someone who depends on a regular paycheck from a single firm. Charlie Munger, Vice-Chairman of Berkshire Hathaway, is a great example of this latticework approach. When Warren Buffett presents an opportunity, Munger has no fear about telling him what he really thinks. While Munger does not have the title, he clearly acts as the Berkshire CRO.

A best practice leading indicator has risk officers rotating into other senior management roles. The reviewer should be skeptical in their approach but stop short of telling the management team how to run the company.

Concentration risk

One way to reduce overall risk is to diversify, spreading risk to limit the impact of a single event. This can avoid concentration around a specific risk such as product, geographic region, asset class, sales person, supplier, leverage, lack of liquidity, or decision making. One risk ORSA reviewers should consider is the risk that decision making is concentrated in a handful of people. As the SOA says, Risk is Opportunity, and in this case it can be a positive or negative. If the CEO drives all decisions, and many companies choose this path, the company is more likely to experience outlier performance, either better or worse. Many boards are hesitant to make waves and do not provide the oversight assumed by other stakeholders.

Time Horizon and Emerging Risks

It is very important for risk teams to consider exposures across various time horizons. The natural tendency is to put out the short-term fires first, but risks that are building should be highlighted in an ORSA review. Mitigation efforts get harder to implement, and more costly, as an event gets closer. Some crises take many years to become material and then dominate the discussion. Emerging risks potentially nearing a tipping point include federal entitlements, such as Social Security, and climate change. Small adjustments made a few years ago may have been sufficient, but prior inactivity increases the future challenge. Few risk managers think beyond the current tactical business plan extending 3-5 years into the future. The ORSA reviewer should consider risks that will be material beyond the normal regulatory cycle. By spending time thinking and assessing qualitatively over longer periods, a company develops competitive advantages with proactive development plans. Experienced practitioners can brainstorm a risk and how it might interact with the current risk profile, providing value without a large budgetary commitment.

Stress Testing

Sensitivity testing and scenario analysis should focus quantitatively on tactical plans, with up to 10 scenarios created to test specific risk exposures, including some that interact. Consistency is important but several should be considered wild cards, changing annually based on current concerns and developments. Risks that could change over longer periods of time should be documented, assessed and planned for. This can often be effectively considered qualitatively. For an insurer these could include higher/lower mortality/morbidity, an extreme earthquake, geomagnetic storms or an inflation spike. Companies should be creative in identifying emerging risks, thinking outside of their comfort zone to include such risks as climate change, regional conflicts, infectious diseases, negative impact of fracking operations and regional recessions. This is an opportunity for the ORSA reviewer to question the analysis. Combinations of these emerging risks should be considered, incorporating correlations and possibly copulas.

Consistent process

An ORSA reviewer should look for a consistent pricing methodology across all opportunities, both organic and external. For an insurer some examples might include inconsistent tax rates or capital charges, marginal versus stand-alone pricing, and inconsistent hurdle rates (opportunity cost). A best practice firm will measure itself consistently so that the capital allocator (generally the CEO) can compare opportunities.

The reviewer should look for evidence of efficient markets thinking as well as intrinsic value and qualitative risk considerations. If current conditions show markets outside their normal range, companies should consider this and document the potential impact to their risk exposures.

Being overly focused on recent results leads to anchoring and poor decision making. Sometimes we misunderstand the drivers, such as yelling at bad behavior and celebrating good behavior only to have both revert to the mean during the next measurement period. Being aware of these human frailties associated with behavioral finance help risk managers avoid common mistakes.

Diversification and liquidity is plentiful when conditions are good, but when bad things happen correlations increase. For hidden and misunderstood risks, diversification, excess capital and risk culture play key roles in building resilience so a firm is able to fight through tough times.

Experience

The inexperienced ORSA reviewer will think differently than one who has lived through extreme events. Those who recently completed their technical training tend to focus on downside risk, while a little experience leads the reviewer to prefer optimization techniques and finally (generally after the "optimal" models blow up) the experienced reviewer tries to manage the risk of not meeting corporate goals and maintaining solvency. By retirement he is starting to understand that he knows what he doesn't know, and that it's still quite a bit. Experience and wisdom pays dividends, perhaps even more when the review involves aggregating risk exposures.

Conclusion

An ORSA reviewer wants the firm to succeed and be resilient when the inevitable downturns occur. A holistic assessment of risks, with aggregation across business units and risk silos while considering interactions, will lead to better understanding of risk exposures by the reviewer. Multiple perspectives, including those that are contrarian, should be noted and encouraged. Best practices will include those that consider longer time horizons and are involved in the strategic planning process.

Reviewers should be skeptical of those who say they have a complete understanding of their risks, as it generally means there are other risks hiding in the dark somewhere close by.

Max J. Rudolph, FSA, CFA, CERA, MAAA, is the owner at Rudolph Financial Consulting, LLC. He can be reached at *max.rudolph@rudolph-financial.com.*