Is ORSA a Good Move for All the Stakeholders?

by Yayuan Ren and Jianwei Xie

The U.S. insurance industry has been doing just fine for so many years without the novel Own Risk and Solvency Assessment (ORSA), which was recently proposed in early 2011. Do we really need ORSA at this point, right after our current self-sufficient system successfully survived the "perfect storm," the so-called once-in-a-hundred-years recession? Or can we employ ORSA as an alternative for not completely following the Europeans' steps on the fancy Solvency II scheme? The answers to these questions rely on whether ORSA is beneficial to the stakeholders of the U.S. insurance industry. If so, ORSA would be a good move. After giving it some thought, we believe that the answer would be a "yes," and the United States would benefit from employing ORSA.

The Insurers

As a great addition to our current insurance regulatory environment, ORSA encourages insurers to improve their risk management, both strategically and technically. Every insurer needs to set up its own risk management procedure to identify, assess, measure, monitor, control and mitigate their risks. Instead of just focusing on satisfying the imperfect regulatory formulae like risk-based capital (RBC), insurers are finally required to do something more creative and to undertake serious effort to develop their own risk management systems. For insurers, ORSA will not be another standardized form or data call to report, but a customized framework and risk management model to serve their own business strategies and risk appetites.

Why is ORSA better? It promotes insurers to think and act more proactively on their own risk management policies, quantitative measurement of risk exposure in both normal and stress environments, implementation of economic capital models and solvency assessment tools. Through carefully completing the three proposed sections for ORSA, the insurers get the opportunity to re-examine and improve their enterprise risk management (ERM) procedures with regular frequency. In return, the improved ERM system will surely help the insurers' business. For instance, with improved risk profiles, it will be easier for insurers to raise capital with lower costs and to conduct the lines of business with the desired risk characteristics that fit their risk appetites.

ERM has been a hot topic in the insurance industry for years, but not all the insurers have set up their own comprehensive ERM frameworks. The implementation of ORSA will definitely draw enough attention of insurance companies' executives to improve the risk management work and therefore promote the U.S. insurers' competitive advantage as a whole.

The Regulators

Who wants to be those kinds of parents who have to take care of their children all the time, or forever? We want our children to be able to do independent rationalization and make reasonable judgments without too much of our intervention, as long as we believe they are ready to be on their own.

ORSA is a great way for regulators to evaluate the readiness of insurers to manage the solvency risk themselves. It is like the parents reading the children's journal to get a comprehensive understanding of the youngsters' thoughts. In my point of view, it does not really matter whether they are ready or not; at least the regulator has something to

©2012 Society of Actuaries, Casualty Actuary Society, Canadian Institute of Actuaries

count on and knows the insurers are trying hard to improve their risk management. In return, the regulators will benefit from the fellow insurers' improved risk management. Isn't it wonderful if your children always proactively think about becoming a disciplined person? For the parents, it means less work on disciplining and more time for other instructive activities. For regulators, thanks to ORSA, they can spend more resources to work on other meaningful projects, such as RBC formulae modifications, regulation on evolving products and evolving market, etc.

The Policyholders

As policyholders, we are happy to see that the U.S. insurance regulators are not completely embracing the uncertain Solvency II regime. In fact, we are glad that we are not abandoning the RBC formulae, which have been acting as a safeguard to protect policyholders from insurers' solvency risk. Although RBC is not perfect, it has proven to be working pretty well especially during the recent economic collapse.

Combined with ORSA, policyholders will be in better hands in terms of the claim payments guarantee in the events of losses. Through ORSA, insurers can realize and allocate assets for the risks not recognized through the RBC formulae, promoting the insurers' solvency. Moreover, ORSA can potentially improve insurers' asset/liability allocations and efficiencies; in return, policyholders can expect better insurance prices as well. For instance, after recognizing the correlations among products through implementing economical capital models, insurers can potentially lower the existing overall loss cost assumption based on the risk diversification effect among the retained risks, leading to lower overall premium charges. As policyholders, we will be more than happy to embrace anything that can lower our premiums and still ensure the claim payments. The policyholders really do not care if you call it ORSA or NASA, Solvency II or Solvency III.

The Investors

There are two big categories of insurance industry investors: debt-holders and shareholders. Debt-holders will easily embrace ORSA since the default risk can be somehow reduced through implementing ORSA. Insurer default risk can be reduced through a sound economical capital model and internal solvency assessment, both preventing insurers from taking excessive risk. When insurers' insolvency risk becomes lower, the debt-holders' benefits are clearly better protected.

Similar to debt-holders, shareholders can also benefit from the managed solvency risk. They will be more confident that their share value is not going to become zero.

Through ORSA, potential investors will be able to learn more about insurers' risk appetite and risk profiles. Such information cannot be obtained from insurers' 10-K or other financial statements. As a result, ORSA provides greater information transparency for investors, especially non-institutional investors, to better understand the investment risk they are about to take. For instance, if ORSA indicates that an insurer chooses 99.5 percent confidential interval for reserving risk, investors can reasonably expect a relatively stable but humble rate of investment return; on the other hand, if the ORSA indicates that the insurer is a risk taker, the investors' return can be relatively big but volatile. ORSA will be a great tool for investors to evaluate the risk and value of insurers and to set up their investment portfolios with desired diversification level.

©2012 Society of Actuaries, Casualty Actuary Society, Canadian Institute of Actuaries

Is ORSA a Good Move ... *by Yayuan Ren and Jianwei Xie*

The Rating Agencies

With the greater transparency that ORSA will bring in, rating agencies will be able to gather more information with regard to insurers' corporate governance and ERM effectiveness. With the improved information, rating agencies can make sounder decision on the ratings for insurance companies. In addition, with the new information added by ORSA, rating agencies can develop comprehensive rating engines to better present the insurance companies' performance.

Moreover, ORSA would also benefit other stakeholders including employees in the insurance industry and the public. Employees will enjoy their more secure jobs when their employers improve their corporate governance through ORSA. For the public, the implementation of ORSA will help build the confidence on the insurance industry becoming less vulnerable to economic volatilities. With better ERM practice carried out by the entire U.S. insurance industry, taxpayers' money will be far less likely to be exposed to the insurance industry bailout bills.

Yayuan Ren, Ph.D., is an assistant professor at Illinois State University in Normal, Ill. She can be contacted at *yren2@ilstu.edu.*

Jianwei Xie, ACAS, ARM, MAAA, is an actuary—Commercial Specialty, at Argo Group US in Chicago, Ill. He can be contacted at *jxie@argogroupus.com.*

©2012 Society of Actuaries, Casualty Actuary Society, Canadian Institute of Actuaries