JOINT RISK MANAGEMENT SECTION

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HOW TO REVIEW AN ORSA

Co-Sponsoring Organizations:

How to Review an ORSA

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Introduction

A major objective of the Own Risk and Solvency Assessment (ORSA) initiatives now under way around the world is to allow stakeholders such as boards of directors (BODs) and regulators to more easily and transparently assess the state of enterprise risk management (ERM) in an organization.

ORSA regulations and guidance, such as the NAIC's guidance manual in the U.S. and OSFI's guidance manual in Canada, are intentionally non-prescriptive; regulators are essentially asking companies to self-assess components of their ERM framework as a way to tell stakeholders their ERM story and explain why that story makes sense for the organization.

Consequently, most ORSA regulations are flexible enough to permit organizations to use the report for two primary purposes: to meet their internal ERM and solvency assessment needs and to meet requirements related to external regulatory oversight. BOD and senior management buy-in for the organization's ERM framework is an intended result, if not an explicit mandate, of most ORSA regulations. As a result, companies should be creating processes and reports that meet their internal management and strategic needs as well as satisfy regulatory requirements. Companies that focus first on these strategic, planning, and internal risk management aspects are likely to benefit much more from ORSA than those who treat the requirements merely as regulatory exercises.

A variety of stakeholders, including regulators, representatives of rating agencies and BODs, will act as reviewers of ORSA reports. Rather than resorting to a "checkbox" approach, reviewers should strive instead to understand the story the company is conveying, and whether it fits with sound risk management practice for that particular organization.

Back to the Basics: What Is ORSA Trying to Accomplish?

The basic purpose of the ORSA — an assessment of current and future solvency according to the unique characteristics of the company and its internal perspectives on risk — sets the high-level context for a review. As such, ORSA reports should help reviewers answer a few fundamental questions:

- Is the company managing its risks in a manner that fits its size, scale, and complexity?
- Is the qualitative risk management employed by the company adequate for the risks it faces?
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Each company's unique situation should be reflected in the reports. For example, a large multi-national multi-line writer should manage its risks differently than a regional mono-line carrier.

In the process of investigating these fundamental questions, reviewers should focus on several key topics, as described below.

ERM Framework

The ERM framework forms the foundation of a company's ERM program. The framework's design should be based on the unique characteristics of the business and supportive of the company's perspective on risk. A key element is an articulation of the company's risk appetite, including the associated risk limits and tolerances used to monitor its implementation. Other important elements of the framework are an organization-wide risk culture that supports the company's attitude toward risk, and a risk-based structure for management decision-making. The reviewer should evaluate whether these elements are present and whether they are suitable for the company's unique situation.

Quantification of Risk Exposure

The assessment of risk exposures is a major component of the ORSA and should begin by identifying and describing each material risk. This process is intimately related to the unique business of each company. Although some commonality between companies can generally be expected (e.g., life insurers of all sizes would almost certainly want to analyze their mortality risk), a reviewer should not strictly compare the set of risks appearing in an ORSA report against a predetermined checklist, but should instead consider whether those risks adequately reflect the nature of the company's business.

For each material risk, the ORSA report should describe the assessment methodology and the results of that assessment. Once again, a reviewer of this process should resist the urge to rely on comparisons to a predetermined checklist. For example, requiring all insurers to model liability losses with a lognormal distribution would not be consistent with the spirit of the ORSA. Instead, a reviewer should seek to understand how each risk exposure is assessed and whether the approach is appropriate for the risk and the company's unique business.

Capital Modeling and Prospective Solvency Assessment

Risk and capital modeling is another area where the application of universal standards should be avoided. For certain companies (or even for certain risks within an organization), a complex probabilistic approach to modeling risks is likely warranted, while for others, something more simplistic and scenario-based may be appropriate. In many situations, some combination of the two approaches (stochastic and deterministic modeling) is likely best. However, not all companies should be held to such a standard. It is more important that the company's ORSA report demonstrates it has considered such options and has followed appropriate principles in selecting an assessment approach.

The ORSA report should evaluate whether the capital available is sufficient to protect the company from future insolvency over the business planning horizon, within the context of its risk profile and strategy. If the company assesses its future risk exposure following sound practices and determines that its risk of insolvency exceeds internally established limits, this should not be deemed a failure of the ORSA; rather, the ORSA in this case has successfully provided senior management with the appropriate insight to take corrective action.

Governance and Controls

Critical as they are for an effective ORSA, risk quantification techniques by themselves are not sufficient. In addition, there must be a structure in place to ensure that systems are connected, processes are carried out, and results are communicated and analyzed at the appropriate level. Consequently, a risk governance structure and a system of internal controls form an important underpinning to ERM, and the ORSA report should describe this infrastructure and its role in risk management.

Different governance structures will be appropriate for different organizations; for example, a single risk committee might be able to efficiently monitor the operations of a small insurer with homogenous products, while a complex global organization may require multiple teams with expertise in specific products or categories of risk. The reviewer should evaluate whether the report provides confirmation that an appropriate governance structure has been established and maintained, and whether the insurer has considered how effective this structure is within the context of its culture, objectives and appetite for risk.

Traditional risk management practices — including monitoring exposure to key risks and maintaining internal control processes to assure that risks taken are within the company's risk tolerances — remain important elements of an overall ERM program. Risk monitoring should take place routinely at all levels of the organization, and the processes should be documented in the ORSA report. It should also assess whether internal controls are effective and efficient in light of the company's risk profile, and provide assurance that the company is in compliance with its self-determined control structure.

Conclusion

Reviewers should look for a clear demonstration of solid risk management principles rather than prescribed approaches in ORSA reports. A company's risk management approach should not be unnecessarily complex or secretive, and a reviewer with the appropriate qualifications should be able to understand the thought process and conclusions described in the ORSA report. If a qualified reviewer is unable to do so, it could indicate underlying uncertainty or problems with the company's overall risk management framework, the ORSA report itself, or perhaps both.

The overarching theme and intent of ORSA regulation is to enhance and/or prompt sound risk management practices in the industry, a noble endeavor and one that should benefit both individual companies and the industry as a whole. Reviewers can help the effort by focusing on the broader issues of a company's overall risk identification, assessment and mitigation within the context of its business. By avoiding a cookie-cutter approach to an ORSA report, the reviewer will gain a clearer picture of each company's individual risk philosophy and processes, and best meet the spirit of the global ORSA initiatives.

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