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HOW TO REVIEW AN ORSA

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How to Review an ORSA

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How may a regulator review an ORSA? Or an external consultant validate the ORSA? By its very nature the ORSA will be bespoke to the firm in question. There is no "one size fits all approach" to reviewing ORSAs but there are some common themes which should be born in mind.

ERM framework

An ORSA is only going to be as good as the insurer's underlying ERM framework. If this does not capture risks properly then there will be gaps in the risk assessment part of the ORSA; while any assessment of solvency is moot if controls are weak. An ORSA review should start with the ERM framework.

A key question is "how are risks identified?". There review should consider what processes are in place to identify both the risks arising with new insurance products and asset classes, and changes in the nature of existing asset types and liabilities. Another mark of the quality of the ERM framework and of risk identification is the extent to which emerging risks are considered and tracked.

Having identified risks, a good ERM framework should monitor and report on these to senior management. Risk reports should also be reviewed to gauge the quality of risk reporting and how risks and issues are escalated.

Finally, an ERM framework is useless if it is not complied with. An ORSA review should consider internal audit reviews and compliance reports to gauge the strength of the framework.

Reviewing current risk profile

Having gauged the adequacy of the underlying ERM framework, the next step would be to gauge the quality of the current risk assessment which is the starting point for the ORSA. It is important to consider the granularity of the assessment. It is not sufficient to just consider equity risk for example – there needs to be consideration of components such as stock specific risk, beta, dividends etc.

The solvency assessment element of the ORSA will generally be based on economic capital models of risks. A good ORSA will recognize the limitations of these models. While these may not be material at present, the review should consider if they may be going material forward.

Operational risk requires particular attention. It is a very diverse category, there is usually a lack of quantitative data and hence a reliance on subjective scenario analysis. The reviewer should look for evidence that a wide range of risks have been considered and that the scenarios have been subject to rigorous review and challenge.

The review should also consider how well defined benefit pension scheme risks are covered. Pension scheme risks may not be fully addressed in Pillar I but the ORSA should reflect this.

Projecting risks and solvency

Starting from the current risk profile, the ORSA will project this profile and the associated solvency requirements over the medium term. This projection will reflect the insurer's strategy for new business, investments, bonus distributions and dividends. The review should consider how well these projections reflect these plans.

For new business, the review should consider how well existing risk models address the risks associated with new business plans. An insurer entering the variable annuity market for example is likely to encounter a complex mix of basis, implied volatility and other risks. The review should consider whether the insurer's models of these risks are fit for

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purpose. Consideration should also be given to the volume of new business – significant growth could place a strain on underwriting and increase the uncertainty around insurance risks. It can also place a strain on processing and lead to increased operational risk losses.

Other strategic initiatives could involve sales and acquisitions of business units as well as outsourcing which can give rise to new risks which the ORSA should capture.

The insurer's plans will also encompass investment strategy. New investment classes such as hedge funds can give rise to new risks which existing models may not cope with but which the ORSA should capture. The review should also consider the variability of cash returns covering floating rate obligations under swaps and borrowings.

Risk strategy may envisage increased hedging and risk transfer but the review should consider whether associated residual risks such as basis risk have been properly reflected in the assessment.

The bonus strategy for participating business can have a significant impact on solvency. The review should consider how assumptions for bonus distribution tie in with what has been promised to policyholders.

The ORSA should reflect planned dividends as well as interest on debt obligations. In terms of maturing debt, the ORSA may assume this is rolled over. If so, the terms assumed for new debt issues should be reviewed.

ORSA solvency projections need to reflect two different perspectives of solvency: the insurer's own assessment of economic capital requirements based on its risks and models; and Pillar I regulatory capital requirements. There has been convergence between the two bases under Solvency II but there will still be residual differences between the two calculations which the ORSA should be able to reconcile.

Stress and Scenario testing

A single base projection will rarely be enough to assess future solvency needs: it should be supplemented by alternate projections in a variety of scenarios. Many insurers may project own funds on a stochastic basis. While useful in highlighting the sensitivity to different market conditions, correlation and other assumptions underpinning the stochastic model should be reviewed and challenged.

Stochastic models should supplement not replace analysis of holistic scenarios encompassing market and non-market risks. A good ORSA will consider a range of economic (e.g. oil shocks) and other scenarios (e.g. pandemics); and their impact across all risk categories. The review should consider if there are any risk categories which may be impacted by the scenario but which have not been considered by the ORSA.

Scenarios will impact on new business. Some will have a negative impact on sales, but the ORSA should also consider upside scenarios (e.g. a competitor leaving the market) which boost new business as this could place a strain on solvency.

The review should check if a wide range of subject matter experts was consulted in deriving scenarios to ensure they are as realistic and comprehensive as possible. It should also consider the review, challenge and sign-off process to gauge how scenarios were quality assured.

Often economic and other scenario impacts are derived by "gut feel" in scenario workshops and may not stand up to scrutiny. Comparing these against internal model distributions can help improve rigour of scenario assumptions, while helping meet Solvency II validation and use test requirements.

Management actions

The ORSA will assume management actions as part of its response to adverse scenarios. The review should consider whether the timescales assumed are reasonable. Markets

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may fall faster than expected while cuts to bonuses on participating policies may also be held up by the governance process for these.

The review should also consider market access. In falling markets put option protection may become prohibitive. Similarly, a general insurer may not be able to secure replacement catastrophe reinsurance after a catastrophe.

Last but not least, the review should consider the risk of legal and regulatory challenges to proposed actions such as bonus cuts.

Liquidity risk

ORSA projections typically focus on the amount of assets versus liabilities, but there is another dimension to solvency and that is the liquidity of assets and liabilities. A good ORSA should project liquid resources and requirements allowing not just for expected outflows such as maturities but also potential outflows in stress conditions e.g. mass surrenders. It should also reflect potential liquidity strains from margin calls on derivatives.

The insurer should have contingency funding plans to mitigate liquidity strains but the review should validate these. Planned sales of marketable securities should be validated against the size of the market in stressed conditions. For instance, the market for many fixed income securities disappeared during the financial crisis in 2007-2009.

The insurer may look to access repo funding as part of its contingency plans, but the financial crisis highlighted that repo markets may seize up for all but the highest quality assets.

The review should also consider liquidity risk reporting to gauge whether management action timescales assumed are reasonable.

Conclusion

The review should ensure that the ORSA is not a stand-alone assessment but flows from and is consistent with the strategy and plans of the insurer. It should also look for evidence of a deep understanding of risks faced; a framework to control these as far as possible; and robust models for assessing the capital required to cover residual risks. There is a considerable amount of information required for such a review, but a robust ORSA process should ensure that source documents are identified and readily available. Finally, reviewing an ORSA is not a trivial task but will yield a deep understanding of the insurer's risk profile and the strength of its risk management framework.

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