Some Key Questions an ORSA Should Answer

by Loïc Chenu

Introduction

Risk management functions in insurance companies have soared in recent years, and even more so due to the late 2008 financial crisis. With this as background, U.S. and EU regulators—the National Association of Insurance Commissioners (NAIC) and the European Insurance and Occupational Pensions Authority (EIOPA)—are putting in place an Own Risk and Solvency Assessment (ORSA) process, of which the goal is to provide the regulatory framework for risk management.

In this paper, we will first define our understanding of an ORSA process by articulating both the quantitative and qualitative elements at stake. We will then go over the main questions the ORSA should answer, in our opinion.

What Is ORSA?

We suggest the definition of ORSA as a process through which the insurance body checks the current and future alignment between its risk management policy and its solvency level.

This definition highlights two aspects of ORSA. The first is qualitative and leads to the implementation of a risk management policy that is both:

- Prevention, addressing the question: How to prevent an adverse event to occur? and
- Remediation, offering action plans to implement in case of adverse event occurrence.

The preventive approach, placed upstream, is almost exclusively owned by the internal audit. The remediation approach, downstream, is naturally owned by the decision makers that can shift the risk exposure.

The quantitative aspect of ORSA includes the solvency level. In our opinion, it should not be limited to a regulatory ratio; but should be understood at the company's solvency as seen by itself, taking into account its strategic development plan. In that sense and as ORSA should be applicable to companies regardless of their size and activity that could vary widely from one to the other, it would be preferable to have the ORSA regulation to focus less on the implementation and more on the objectives. These objectives should address the following questions:

What Are the Risks Facing the Company?

The risk map should be the first step in any ORSA process. It should identify the events, should they occur, that would be adverse to the company's interest in order to allocate correct solvency capital down the road. In order to have this risk map efficient, the major risks should be identified and could benefit from an individual capital allocation and non-major risks that could have capital allocated jointly.

What Is the Impact of Each Risk on Company's Surplus?

The impact estimate of a risk on company's surplus should be owned by the actuarial function. It should compute this prospective calculation based on a central scenario. Practically, we think this scenario to be the strategic plan's balance sheet and income statements not under stress. Each major risk identified shall be associated with an event (increase/decrease of interest rates, a CAT event …) applied to the central scenario. The resulting variation of surplus is the impact estimate, according to the severity level, and allows allocating solvency capital accordingly. Please note that not all risks are quantifiable, and expert judgment's type of measure could be used.

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Who Is Responsible for Each Risk Monitoring?

The answer to this question could be illustrated by an organizational chart showing responsibility scope of each decision-making structure for each risk, showing hierarchical links between these structures. This should allow companies to check the absence of conflict of interests between stakeholders.

How Are Risks Monitored?

We suggest that enterprise governance includes implementing key primary indicators (KPIs)—both quantitative and qualitative—assigned to each identified risk, monitored on an ongoing basis to a "risk management" function for monitoring. This function could design a threshold to each indicator above which a decision regarding the risk exposure needs to happen. More than one threshold would be useful to monitor the magnitude of the underlying risk. Two thresholds could be in place: one triggering the agenda of the next scheduled risk committee; the other one triggering an ad-hoc risk committee, including senior management.

Due to their strategic nature, we believe the risk indicators should be simple in order to be both reliable and understood by decision makers, but also by the front line performing the implementation. In that respect, the economic capital models may not be suited for the tasks, especially if they are stochastic in nature.

What To Do After a Risk Occurrence?

We believe an action plan should be articulated for all identified risks, upon occurrence and above the predefined materiality threshold. For each, various actions can be thoughts based on the magnitude of the risk (policy cancellation, asset allocation…). As possible, the cost benefit of each action plan should be measured in order to inform senior management in its decision. The action plan should include reinsurance purchase in case of underwriting risk event, with prior cost estimate in line with the surplus relief provided.

Who Is the ORSA Audience?

As long as the ORSA implementation is not constrained by a voluminous regulatory framework, the process should be first and foremost directed to the company itself; this line of thinking is being shared by the European regulator. Thus, the use of ORSA information by other stakeholders (rating agencies, debt holders …) begs the question of trust in the relationship, which is different from accounting information based on neutral standardized framework for all. To that extent, the building of standardized ORSA indicators, audited through a certified third party, could be an adequate response for financial communication purposes.

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