More than Regulatory Compliance

by Sam Gutterman, Brian Paton and Sunil Sen

Introduction

The fundamental building block for an Own Risk and Solvency Assessment (ORSA) is the internal risk management process and framework. As a result, insurance companies' risk management processes have been receiving more attention by both external and internal sources, including;

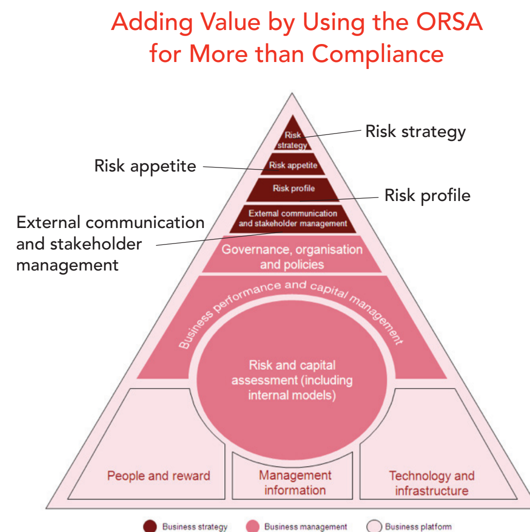
- Rating agencies, due to the potential impact of a risk management process on company ratings;
- Regulatory—for example, Solvency II, Office of the Superintendent of Financial Institutions (OSFI) "vision," and now the National Association of Insurance Commissioners' (NAIC's) ORSA; and
- Internal management—for example, as a lesson learned from the global financial crisis.

The ORSA report should not only satisfy a compliance requirement, but at the same time should serve as an opportunity to document the internal risk management processes and quantitative assessments a company currently utilizes. Producing the document may also enhance internal transparency and identify shortcomings in the existing risk management framework. It will also provide more internal visibility of its underlying contents.

The NAIC's ORSA guidance manual will require companies (that meet certain criteria, including a minimum size) to include required qualitative and quantitative information on how risks are identified, measured and managed.

If the ORSA is regarded only as a regulatory compliance hurdle with the document produced to meet the minimum requirements, then it is highly likely that the full value of the ORSA will not be obtained. To derive optimal value the ORSA should be regarded as a process rather than just a document. As a result, risk management can be better considered as part of business planning. This can create a cohesive direction for the company and avoid an approach based on independent processes and siloed activities. It can then be leveraged to bridge existing gaps in risk management processes, and introduce risk and business reporting feedback loops to further enhance shareholder value. As such, the results and findings of such a process would become integral metrics used by a company's board for monitoring performance, decision making and strategic planning.

Adding Value by Using the ORSA for More than Compliance



Regarding the ORSA as a process with regular metric reporting and feedback loops requires its integration with existing business and strategic planning processes. If integration is not achieved, it will be difficult to determine whether risk appetite, limits and thresholds are consistent with business and strategic plans for the company. This can result in the potential for competing organizational goals. Without alignment, risk management actions to stay within appetite levels may adversely affect a company's ability to meet its business plans, or vice versa. Decisions to meet plan objectives could cause breaches in risk limits; such a breach represents an operational red light, while getting close rep-

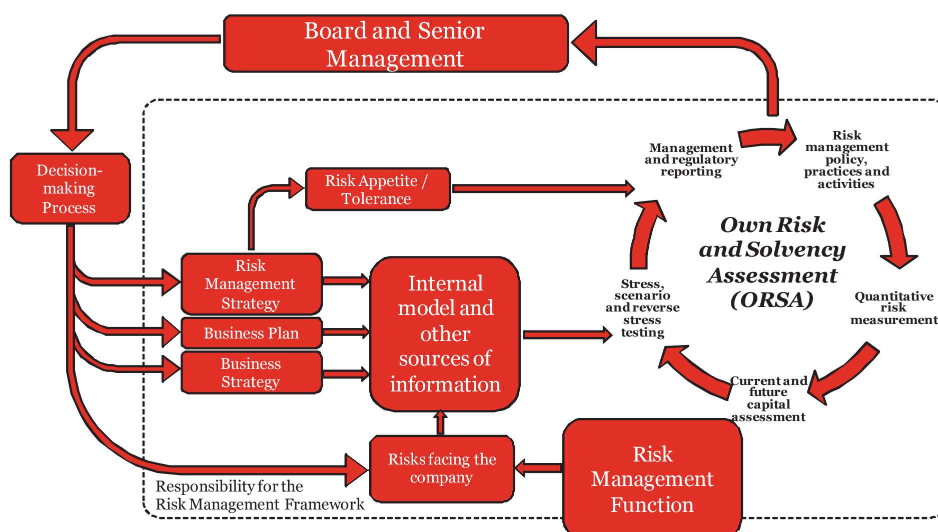
©2012 Society of Actuaries, Casualty Actuary Society, Canadian Institute of Actuaries

resents a yellow. Linking the ORSA to the overall business planning process and determining appetite, threshold and risk limits that meet risk and business objectives is a first step in the process to being able to use it to enhance shareholder value and gain competitive advantage. In doing so, emphasis should be placed on the interaction between the wide-ranging aspects of business strategies (including pricing/product design, distribution and investment strategies, operational/cost control strategies and IT strategies). Business issues today are far too complex to continue with a silo approach, particularly when considering strategic direction.

Creating an appropriate feedback loop is also important. For example, the current year's ORSA process should include an assessment of the effectiveness of last year's risk management mitigation techniques and lessons learned from the prior process. It should include an action/mitigation plan, including risk tolerance/budgets in key risk areas specific to the company, aligned with risk appetite and with regular high-level checkpoints. The integration with business planning means that the management of risks becomes an integral part of how business objectives are met rather than a competing requirement.

In addition, the monitoring process needs to be embedded in a dynamic basis into everyday decision making. In attempting to do this, it is helpful to think of the different types of risk that need to be considered. The ORSA will require companies to consider all relevant and material risks, and therefore will include risks of an operational and strategic nature, as well as the more commonly addressed underwriting and investment risks. Risks can therefore be broken down into those that may arise in the relatively immediate term (for example, hedging risks or fraud), those that arise over a business planning horizon (for example, concentration, policyholder action and regulatory risks) and those that have an even longer nature (for example, distribution channel risks and risks due to consolidation of operations).

Considering the different types and expected horizon of risks is essential to construct and manage both retrospective and forward-looking early warning metrics and indicators. As a result, metrics for key short-term operational and asset-liability management (ALM) risks may need to be produced and managed on a daily basis, with corresponding monitoring and potential escalation to the risk management governance process as appropriate. For example, investment decisions should be monitored frequently with input from risk management and corporate strategy departments to ensure these risks remain within appetite. During the fi-



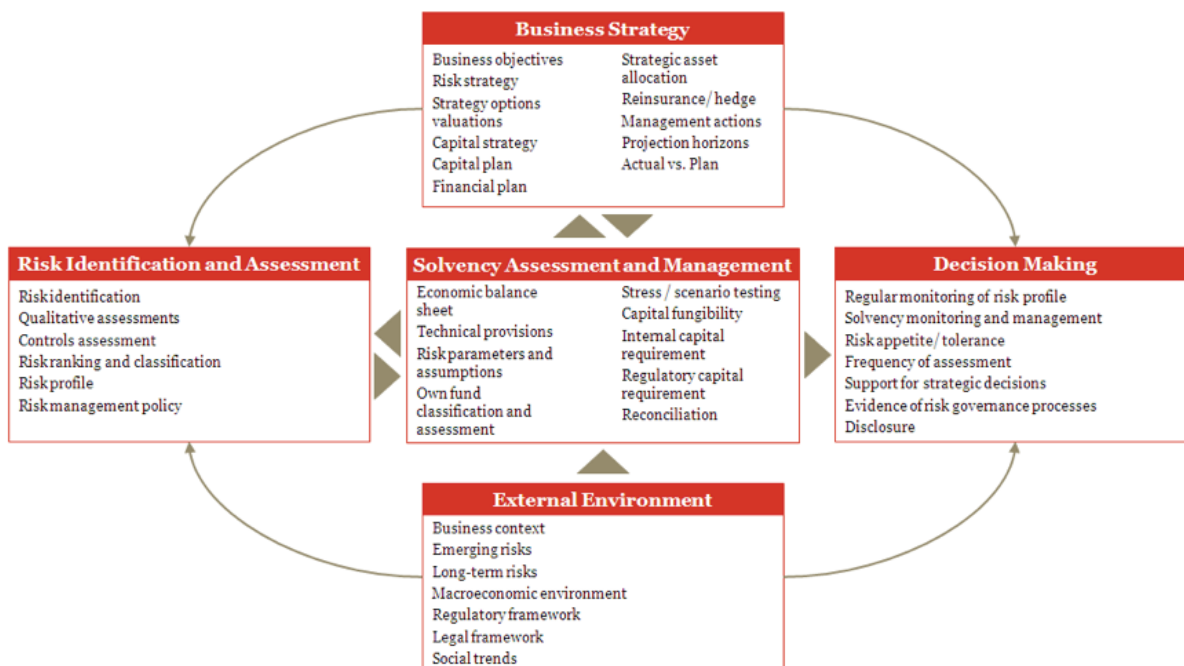
©2012 Society of Actuaries, Casualty Actuary Society, Canadian Institute of Actuaries

More than Regulatory Compliance *by Sam Gutterman, Brian Paton and Sunil Sen*

nancial crisis of 2008 and in the current euro crisis, corporate and sovereign bond credit spreads can and do fluctuate widely on a daily basis.

Furthermore, these risks may not be diversified. It is essential that metrics are available at the required frequency so that during such times investment strategy can be adapted to mitigate losses and take advantage of current opportunities. Key metrics used could include credit spreads, key rate durations, option-adjusted spreads and mark-to-model values for illiquid securities.

Similarly for longer-term and strategic risks, the frequency of monitoring would be adapted to the features of the risk. The timing of monitoring and reporting would be designed to react to the timing at which further credible information becomes available and early warning indicators flash. In contrast, current planning processes typically focus primarily on regulatory capital, revenue, operating earnings and current year-to-date expenses that are reported on a monthly or quarterly basis independent of timing of emergence of risk. Although in many cases they incorporate a SWOT (strengths, weaknesses, opportunities and threats) identification process, the follow-through on this analysis tends to be limited and short-term in nature, both in shoring up weaknesses and taking advantage of strengths and opportunities. This may not adequately address risks that arise across the planning horizon, especially tail risk (excessive exposure of any kind). These must be identified and quantified, even on a simple green-/yellow-/red-signal basis indicating the likelihood of such risks and their possible adverse effect. The effectiveness of mitigation strategies and tactics that are designed to address them should also be quantified. Controlling tail risks that may emerge quickly (for example, as evidenced through a surge in sales in what turns out to be an underpriced product, or through excessive concentrations in multiple international subsidiaries) requires metrics that respond to an insurer's position during a financial, natural disaster or pandemic crisis.



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

More than Regulatory Compliance *by Sam Gutterman, Brian Paton and Sunil Sen*

The growing trend is toward the use of "risk dashboards" or risk reporting processes that can quickly allow management to become aware of and respond to changes in key metrics impacting the business. In addition, a controlled alignment of management performance and remuneration is needed, through quantitative measures such as economic valued added or risk-adjusted return on capital (RAROC). This may enhance the embedding of risk management into corporate planning and sales projections, and, coupled with risk dashboards, focus business decisions to contribute to an increase in long-term economic value.

Risk management is often thought of as only a defensive mechanism. However the ORSA process can also be used to identify opportunities to take on further risks to increase shareholder value and create competitive advantage. The process should also produce metrics that allow identification of possible rewards that merit taking on additional risk, particularly where a company believes it may have a strategic or financial competitive edge, such as market experience or a strongly capitalized position.

In Conclusion

To add value to a company, the ORSA should be viewed as being more than a compliance requirement. Rather, it should be considered an integral element of a company's governance, part of its holistic business, risk and strategic planning process used by both management and the board on a regular feedback loop basis. The ORSA process, borrowing enterprise risk management (ERM) techniques, should be used to identify, control and mitigate short- and long-term risks. Carefully constructed metrics can facilitate the process. Furthermore, the value of the ORSA process can be used to exploit opportunities to add value and increase shareholder and policyholder value. Risk can represent an opportunity; the ability of insurers to leverage their knowledge and risk management capabilities can allow them to find and maintain a competitive edge.

Sam Gutterman, FSA, CERA, FCAS, FCIA, is a director & consulting actuary at PricewaterhouseCoopers LLP in Chicago, Ill. He can be contacted at *sam.gutterman@us.pwc.com.*

Brian Paton, MAAA, is a director at PricewaterhouseCoopers LLP in Chicago, Ill. He can be contacted at *brian.paton@us.pwc.com.*

Sunil Sen, ASA, CERA, is a senior associate and consultant at PricewaterhouseCoopers LLP in Chicago, Ill. He can be contacted at *sunil.w.sen@us.pwc.com.*

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