One year to go: An ORSA checkup

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INTRODUCTION

By now, the U.S. insurance industry's preparations for the Own Risk and Solvency Assessment (ORSA) are in full swing. The intended implementation date of January 1, 2015, is less than a year away, and many insurers will soon need to finalize their plans for completing an ORSA and filing the associated ORSA Summary Report.

The National Association of Insurance Commissioners (NAIC) has conducted an ORSA Feedback Pilot Project (Pilot Project) in each of the last two years, providing insurers with the opportunity to take a voluntary "dry run" at completing an ORSA Summary Report. At the conclusion of each Pilot Project, summarized results and general feedback comments were made public.

With two Pilot Projects in the books and 2015 just around the corner, it is time to take stock of the ORSA landscape. What has the industry learned about the ORSA to date? Further, what practical steps can insurers take to prepare an ORSA that both satisfies regulators and enhances the company's market value and solvency position?

We believe that insurers stand to benefit from benchmarking their ORSA preparations against the existing system of risk-focused financial examinations. Key concepts from the risk-focused examination process have featured prominently in the NAIC's Pilot Project feedback, and it is a safe bet that key financial examination procedures will inspire similar elements within the upcoming ORSA review process. While it is also clear that a successful ORSA must go beyond simple imitation of a risk-focused exam, many insurers may gain from leveraging exam lessons into enterprise risk management (ERM) improvements.

In this article, we first review some of the key theoretical underpinnings of the ORSA. We then outline practical advice that may serve as a "bridge to ORSA completion" for the industry and regulatory community, based on our experiences with fundamental risk-focused examination tenets. Finally, we conclude with a few thoughts on industry readiness with the ORSA less than a year away.

WHAT IS THE IDEAL ORSA?

Much has been written on the basics of the ORSA.[1] The theoretical benefits of the ORSA process are relatively clear: The ORSA provides insurers with either the opportunity to showcase strong ERM or the impetus to develop more effective ERM.[2, 3] In either case, the upcoming ORSA requirement should stimulate the development of industry best practices in ERM and encourage their widespread adoption.

Further, the ORSA process marks the continuance of a shift toward "principle-based" regulation and away from prescriptive "rules-based" regulation.[4] This shift brings with it both new opportunities and obstacles for the industry and regulatory community.

On one hand, the ORSA reporting process has been designed to be flexible and tailored to each individual insurer. No two companies face the same set of risks, and none should be expected to produce exactly the same ORSA.[5] In theory, this approach should allow better insight into the key risks facing an insurer: A one-size-fits-all approach to the ORSA would likely be counterproductive to the industry's collective solvency.[6, 7]

However, allowing highly individualized ORSAs will pose review challenges for regulators. Any insurer large enough to be subject to ORSA requirements will have unique models, management structures, and "languages of risk." The greater the flexibility allowed in ORSA reporting, the more difficult it will be for the regulatory community to make comparisons among companies. For this reason, a portion of the ORSA literature argues for a set of uniform scenarios and metrics to be provided by all insurers in the Summary Report.[8]

1 For an overview and introduction to key ORSA concepts and issues, please see: Blackburn, W., Killough, M., Schwartzman, J., & Suchar, C. (April 26, 2013). Planning for NAIC ORSA. Milliman Insight. Retrieved November 1, 2013, from http://us.milliman.com/insight/pc/Planning-for-NAIC-ORSA/.
2 Gutterman, S., Paton, B., & Sen, S. More than Regulatory Compliance. *Risk Metrics for Decision Making and ORSA*. Joint Risk Management Section of the Society of Actuaries, Casualty Actuarial Society, and Canadian Institute of Actuaries, pp. 27-30.
3 Shapella, A. & Stein, O. Understand ORSA Before Implementing It. *Risk Metrics for Decision Making and ORSA*, ibid., pp. 34-37.
4 Vaughn, T. (February 2009). The Implications of Solvency II for US Insurance Regulation. Networks Financial Institute - Indiana State University.
5 International Actuarial Association (August 11, 2008). Practice Note on Enterprise Risk Management for Capital and Solvency Purposes in the Insurance Industry.
6 Rudolph, M. Focusing on Own Risk of the ORSA Process. *Risk Metrics for Decision Making and ORSA*, ibid., pp. 31-33.
7 Shapella & Stein, ibid.
8 D'Arcy, S. Clarifying Uncertainty. *Risk Metrics for Decision Making and ORSA*, ibid., pp. 21-23.

ORSA IN PRACTICE: THE FEEDBACK PILOT PROJECTS

The two Pilot Projects provided a laboratory for fine-tuning the industry's approach to the ORSA. Regulators' public feedback identified the following shortcomings (among others) related to the submitted "sample" Summary Reports:[9]

- A tendency for insurers to simply attest to the existence of risk limits instead of describing them
- A lack of explanation of the methodologies underlying insurers' internal capital models
- A need for some insurers, especially life insurers, to provide additional stress testing on liquidity rather than a single focus on capital
- A need for some insurers to more clearly identify internal "risk owners" and key risks

It is worth noting that the NAIC ORSA Working Group explicitly refrained from leveraging the above observations into further prescriptive requirements in the ORSA Guidance Manual. Instead, they characterized them as items that insurers "may choose to consider" when completing Summary Reports.

This approach of "comment but don't codify" preserves the ORSA's flexibility and should be healthy for the long-term prospects of the ORSA. Nevertheless, it may cause some short-term frustration for insurers trying to grasp what the ORSA might mean for them. So how can they best meet regulators' expectations, particularly when there is still some lack of definition regarding what the full extent of those expectations might be?

ORSA IN PRACTICE

Successful Summary Reports will exhibit mastery of both the substance and presentation of the ORSA.

- **Substance:** Insurers must possess a robust ERM culture and a diverse tool kit of risk controls.
- **Presentation:** Insurers must clearly communicate to outside parties how their ERM is part of the operational and financial management of the enterprise.

On the ORSA, communication is key: Insurers must distill an entire organization's culture and processes into a high-level overview that will be a focal point of regulatory review. Thus, it should not come as a surprise that many Pilot Project feedback comments focused on presentation rather than advanced quantitative topics (e.g., economic capital modeling methodologies).

Determining how to best structure and present an ORSA can be a daunting task. The literature related to corporate risk management is vast: It sometimes seems that there are almost as many sources of ERM advice as there are insurers seeking to improve their ERM. As a result, insurers must ask (and find answers to) targeted, actionable questions such as:

- What is the minimum set of risks that must be identified and addressed by a sufficient ERM program?
- How are those risks correlated?
- What are the appropriate connections between an ERM program and the decisions of the company's management and board of directors?
- What are the key concepts or terms that should be used to discuss risk consistently on a company-wide basis?

One of the best sources for answering the above questions is already familiar to all insurers—the existing risk-focused examination process. To close observers of trends in solvency regulation, this should come as no surprise. Starting from the transition to risk-focused exams around 2008, solvency regulation has increasingly focused on reviewing company processes in addition to financial statement figures. In many ways, the ORSA is the logical extension of this trend—except that now, instead of relying on financial examiners to guide a review, responsibility is placed in the hands of the insurer itself.

As a result, there are at least two key reasons for insurers to benchmark their ORSAs against risk-focused examinations. First, it allows them to leverage the NAIC's decade-long research into risk and its mitigation, which serves as the basis for the risk-focused exam process. Risk-focused examination procedures can serve as a reasonability check for management, letting them compare their ERM practices to industry standards to identify areas of potential improvement.

Second, benchmarking against the risk-focused examinations will likely produce ORSA Summary Reports that are more accessible to regulators. This in and of itself should not be an end goal of the ORSA: In fact, the NAIC explicitly advises that companies should provide regulators with ORSA exhibits that are originally intended for the company's board of directors, and not vice versa. However, a Summary Report that clearly exhibits tenets from the risk-focused examination process should help set the insurer on the path toward streamlined regulatory review in the future. The stated intent of the NAIC is to eventually make the frequency and depth of financial examinations dependent upon the success of that insurer's ORSA. Because all insurance groups of a certain size are required to complete an annual ORSA, those that have to expend resources on substantial and potentially redundant risk-focused examinations will operate at a competitive disadvantage.

9 Tessier, D. (October 15, 2012). ORSA Feedback Pilot Project lands with little turbulence. Property Casualty 360°. Retrieved November 1, 2013, from http://www.propertycasualty360.com/2012/10/15/orsa-feedback-pilot-project-lands-with-little-turb?t=erm.

RISK-FOCUSED EXAMINATIONS:
SAMPLE KEY CONCEPTS FOR ERM AND ORSA

The financial examination process is extensive. Insurers looking to benchmark against the risk-focused examination standards on a particular issue can find source material in the NAIC's Financial Condition Examiners Handbook and their own prior exam experiences. However, we have seen a few key issues come to the forefront of discussion across several risk-focused examinations. A partial list of potential risk-focused exam lessons is below.

When completing an ORSA, insurers should consider how best to:

- **Assess both the frequency and severity of risks.** Some insurers present risks along a single continuum (low, medium, high)—or simply provide a listing of "important" risks. Assessing all risks along two dimensions allows for added insight into solvency evaluation (for example, low-frequency/high-severity risks are likely to be a bigger threat to solvency than high-frequency/low-severity risks). It also helps identify optimal risk mitigation strategies for a given risk.

- **Consider the entire horizon.** Certain insurance liabilities have long duration, which increases exposure to financial risk. This is especially true in the life insurance industry. What seems like a reasonable risk strategy in the short term may lead to suboptimal outcomes in the long term, while the opposite may also be true.[10]

- **Quantify risk for comparability.** At a high level, this can be as simple as estimating the potential impact of a risk as a percent of surplus or reserves. Admittedly, not every risk is easily expressible in such terms. Additionally, there is sometimes a temptation to overstate precision and understate uncertainty once numbers are assigned to qualitative risks. Nevertheless, placing risks into numerical terms provides a picture of potential materiality for outside observers. Quantification also helps management prioritize mitigation efforts across types of risk that otherwise might be difficult to compare (for example, operational risk and reserve risk).

- **Identify the right risk metrics.** The life insurance industry has seen an increase in the complexity of its products in the last decade, from variable and indexed annuities with living benefits to variable universal life with secondary guarantees. Identifying which risk metrics to use can pose a challenge when preparing an ORSA. It is important that the metrics used be in line with the way senior management thinks about risk.[11]

- **Strike the right balance between complexity and practicality.** Similarly, while models need to accurately capture the inherent risk profiles of the products, doing so may result in highly complex and inflexible models. It is important that life insurers strike the right balance between having an approach that is sufficiently complex in providing reliable, accurate, and granular information, yet simple enough that results can be produced quickly and clearly enough to be used by management. The use of proxy models should be considered, as these are more nimble in running "what-if" scenarios.[12]

- **Assign a company control for every risk.** A key risk-focused examination tenet is that insurers should have an internal risk mitigation technique for each material risk they face. This holds true regardless of whether external partners (such as consulting actuaries or third-party administrators) provide the insurer with risk support in their areas of expertise. For small insurers, resource limitations can justify some degree of external risk delegation (particularly for highly technical areas such as actuarial reserve reviews). However, for large insurance groups subject to the ORSA, regulators are likely looking for clearly defined internal controls for all material risks.

- **Fully document both the planning and execution of each risk mitigation strategy.** The risk-focused examination process uses a hierarchy of evidentiary techniques to assess risk controls. Inquiry, or having the insurer provide descriptions of the control process, is considered the weakest form of assessment. Inquiry alone is not usually suitable for reaching a conclusion of strong risk controls. Regulatory observation and/or re-performance of controls are considered sequentially stronger forms of assessment, but are more suited to a financial examination than a Summary Report review. Examination of documents, or using an existing audit trail, is considered the optimal form of control assessment. Insurers that show clearly documented intent and a consistent, repeatable process for each control are likely to have the most efficient dealings with regulators in the ORSA process.

- **Put more emphasis on stress scenarios and correlation among risk, especially at extreme values.** The recent focus of the life insurance industry on economic capital has seen more evaluation as of a standard valuation date and less analysis and insights as to how capital, profitability, and liquidity are impacted over time under different strategies and scenarios. The NAIC pilot feedback specifically mentioned the importance of providing additional stress testing on liquidity rather than a single focus on capital.[13]

10 Brière-Giroux, G. & Scanlon, M. Effective Risk-Based Decision Making: ORSA and Beyond. Risk Metrics for Decision Making and ORSA, ibid., pp. 40-43.
11 Brière-Giroux, G. & Scanlon, M. ibid.
12 Brière-Giroux, G. & Scanlon, M. ibid.
13 Brière-Giroux, G. & Scanlon, M. ibid.

ONE YEAR TO GO: TRENDS AND OBSERVATIONS

At the end of the 2013 Pilot Project, the NAIC ORSA Working Group reached a conclusion that should inspire industry optimism: Out of the 22 submissions received, only three required "material improvements" to appropriately reflect the insurer's ERM frameworks.[14] However, it is probably not appropriate to generalize to the conclusion that it will be easy for most insurers to get ORSA right the first time around. It is likely that the insurers volunteering for the Pilot Projects exhibit strong ERM planning and a high level of investment in ORSA preparations. By the NAIC's own estimation, about 250 insurance groups will be required to file Summary Reports under the Model Act's requirements.[15] For the majority of large insurers, there will be no test run before the time arrives to complete an ORSA "for real."

In addition, while a recent Milliman survey of life insurers found that more than 60% of respondents qualified their existing ERM process as Excellent or Strong, only 20% of respondents currently prepare a report that is materially similar to an ORSA. More importantly, only 5% of respondents consider themselves ready for ORSA.[16]

However, unprepared insurers may end up catching a break from state legislatures. As of October 2013, only seven states (mainly Northeastern states and California) had passed ORSA-related legislation.[17] Without significant legislative progress in 2014, it is likely that the ORSA's intended implementation date will arrive without an ORSA requirement for many (or most) of the nation's large insurers.

Nevertheless, insurers should not delay preparation. The ORSA's base of support extends outside of the United States to European jurisdictions and beyond, and regulatory trends suggest that the ORSA has likely become a question of "when" rather than "if." As a result, even insurers in states currently without an ORSA requirement will benefit from beginning preparations now. Not only will they avoid being caught unprepared if the legislative atmosphere in their state changes—but the benefits of strengthened ERM should also improve their interactions with auditors and credit rating agencies, among others, and enhance business management for remote events.

CONCLUSION

In late 2013, the NAIC announced plans for a third ORSA Pilot Project, giving insurers one final chance to submit a practice Summary Report prior to the intended ORSA implementation date of January 1, 2015. Even with this additional feedback, the industry and regulatory community will likely still be working out bumps in the road when the first "real" Summary Reports are filed. To help smooth the path ahead, insurers should consider benchmarking their ORSAs against the existing requirements of risk-focused examinations. By doing so, an insurer can set itself apart from the competition—profiting not only from smoother interactions with regulators but also, more importantly, from the robust strategic insight and formation of tactical plans that a successful ORSA will bring.

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14 Saenz, D. (November 6, 2013). Own Risk and Solvency Assessment (ORSA) Feedback Pilot Project. Report to Superintendent Joseph Torti III (RI), Chair of Financial Condition (E) Committee.

15 Saenz, ibid.

16 Slutzky, M., Cook, D., Chaudhury, P. & Naughton, C. (March, 2013). NAIC ORSA Life Insurer Survey. Milliman, pp. 5-14.

17 American Fraternal Alliance (October 29, 2013). State Legislative Updates, Own Risk and Solvency Assessment (ORSA). Retrieved January 30, 2014, from http://fraternalalliance.org/advocacy-public-policy/state-legislative-updates/.