ORSA: Three Ways It Can Up *Your* Game

by Carol Stern, FLMI, AIRC, ACS

The ultimate purpose of the ORSA model and its reporting requirement is to give the company's management and regulators a more accurate way to evaluate material risks that might cause an insurer to fail.

There is good news for the industry, since regulators have stated that they will be using the ORSA summary reports to decide which companies should be targeted for risk focused examinations. This should lead to fewer examinations overall for companies with strong ERM programs and well-documented ORSA reports.

Historical Perspective

The Own Risk Solvency & Assessment (ORSA) National Association of Insurance Commissioners (NAIC) Model Law 505 has been called a "game changer" by some regulators and was adopted unanimously by the NAIC commissioners—a rare occurrence. In addition, this new Model Law was made part of the NAIC accreditation requirements for state insurance departments, which means that all states and jurisdictions will likely adopt it without variations. All of these efforts highlight the importance that the NAIC is placing on the ORSA model and puts added pressure on states who want to maintain their accreditation status.

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The ORSA Model Law was enacted by the NAIC as a response to Europe's Solvency II program and it is one part of the NAIC's Solvency Modernization Initiative (SMI). Ultimately, ORSA is intended to be a replacement for the Holding Company Model Act (HCA), whose FORM F risk report will be replaced by filing the ORSA summary report. The adoption of ORSA is seen as non-controversial by most regulators and should move quickly through the legislative process in many states during 2014 for a January 1, 2015 effective date. To date, eight states have adopted the model (IA, NY, CA [1], NH, ME, RI, VT, PA) and seven states have proposed the model (CT, TX, IL, MD, OH, VA, WY).

ORSA might also bring about a cultural change for both regulators and insurance companies, since it brings a new *prospective* view of solvency. This shift requires companies to understand and communicate their company's "story" about the future of their capital management. A group assessment will also be required if an insurer is part of a group of insurers or an affiliate of a holding company. ORSA requires an Enterprise Risk Management (ERM) framework that monitors, assesses, and reports *all areas of risk* within the insurer (and the group, if applicable), including the *quantification of non-financial risks* such as reputation and brand risk.

ORSA and the ERM Framework

The NAIC published a guidance manual for the ORSA Model Law in a revised format in March 2013, available at no charge at www.naic.org. The manual does not prescribe *how* a company should implement their ERM program; regulators want to highlight that not all ERM programs are alike, but that the framework should be "appropriate to the nature, scale, and complexity of the insurer's risks, in a manner that is adequate to support risk and capital decisions." [2]

ERM defined under ORSA is "a risk management framework to assist the insurer with

- identifying (potential risks tied to company objectives/strategic plan)
- assessing (the likelihood and effect of its occurrence)
- monitoring (procedures that mitigate the risks)
- managing (the occurrence and impact) and
- reporting (to the board and regulators, as required)

on its **material and relevant risks.**" [3] The ORSA model gives an insurer complete control of the implementation process and the details of how the program will look, which means a small or medium company may have a very different ERM structure than a large company.

However, Part I of the ORSA Guidance Manual does give specific direction on five key principles of an effective ERM framework:

1. "Risk Culture and Governance – Governance structure that clearly

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[1] Circular Letter 14 (2011) – requires all domestic companies to implement an ERM program and file an annual risk report. It refers to ORSA but does not adopt the Model Law.

[2] NAIC Own Risk and Solvency Assessment (ORSA) Guidance Manual As of March 2013 (www.naic.org/...e_orsa_wg_related_docs_guidance_manual_2013.pdf)

[3] Ibid.

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defines and articulates roles, responsibilities and accountabilities; and a risk culture that enables accountability for risk-based decision making.

2. Risk Identification and Prioritization – An ongoing process that is key to the organization. Responsibility for this activity is clear. The risk management function is responsible for ensuring that the process is appropriate and functioning properly at all organizational levels.
3. Risk Appetite, Tolerances and Limits – Foundational elements of risk management for an insurer is a formal risk appetite statement and associated risk tolerances and limits. Understanding the risk appetite statement helps ensure alignment with risk strategy by the Board of Directors and all levels of management.
4. Risk Management and Controls – Managing risk, including the establishment of controls, is an ongoing ERM activity, operating at all levels within the organization.
5. Risk Reporting and Communication – The transparency provided by such reporting gives key constituents access to the risk-management processes and facilitates active, informal decision-making measures on risk identification and management." [4]

ORSA Responsibility and Governance

One of the biggest changes for insurers is the new ORSA governance structure that clearly defines and articulates roles, responsibilities, and accountabilities. The board of directors is responsible for making the ultimate decisions for risk management policy. This does not mean the day-to-day risk decisions should be made by the board, but that the company must have a risk governance team or risk committee with responsibility for daily oversight with respect to risk management as well as development of applicable policies and procedures for the company to help avoid or mitigate those risks. Under ORSA, the chief risk officer (CRO) will run this risk governance team and report to the board in a regular, transparent manner. The board will set the overall risk policy and make key risk policy management decisions.

Some regulators have indicated that board members will be interviewed as a part of a risk-focused examination based on the ORSA report filing. Boards, unlike in the past, must have sufficient training to make sure they understand their new ORSA role with risk governance responsibilities.

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The risk governance team could be a new function of an existing senior management team or comprised of senior officers with ultimate responsibility for decision-making in their roles as head of various company departments. For a small company, the president or CEO should create a team with at least one other officer and not take sole responsibility for the risk governance. Updating the company organization chart for these new roles and responsibilities can be part of the required documentation of the new ORSA risk governance framework.

If the company does not have a CRO, the risk governance team should immediately appoint either a CRO or, at a minimum, an ERM program director. The program director or CRO (or designee) should begin to take minutes at team meetings and document other steps in the implementation of the five ERM program elements.

ORSA Risk Culture

ERM requires a risk culture in which risk management and consistent use of controls are ongoing activities, operating at all levels within the organization. This includes ongoing assessments for all risks, including risk of criminal conduct (the company's response under the Federal Sentencing Guidelines for Organizations), operational risk, compliance risk, and reputational risks in addition to all financial risks.

The risk governance team must take appropriate steps to design, implement, and modify the program to help mitigate the risks found. A risk culture must sustain accountability in risk-based decision making. To document a risk culture, the company can use all the existing compliance and risk manuals as well as all supporting policies and procedures that make up the framework of the program. Once the ERM program documentation is completed, the risk governance team should formally adopt the program and the team meeting minutes should reflect this adoption. The program should be reported to the board by the CRO for its ultimate review and approval.

The ERM requirement for risk identification and prioritization appropriate and functioning properly at all organizational levels necessitates an effective monitoring and auditing infrastructure. Those controls involve the development of key risk indicators and risk metrics that can be used as red flags for substantive risks. A formal risk appetite statement and associated risk tolerances and limits are foundational elements of risk management for a company and required by the ORSA Model Law.

Risk Decisions

Once an initial risk assessment is complete, the risk governance team is responsible for deciding how to handle each material risk based on the company's risk appetite and tolerance.

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[3] Ibid.

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Managing risk is an ongoing [Enterprise Risk Management] activity, operating at all levels within the organization.

There are four basic ways any risk can be managed:

1. **Risk avoidance.** Take action to avoid the risk, such as process changes, divestiture, or additional controls.
2. **Risk mitigation.** Establish triggers for action to take when the risk occurs and define those actions, such as pro-active outreach or additional controls.
3. **Risk transfer.** Have other entities share the risk, such as through insurance or reinsurance.
4. **Risk acceptance.** Identify the risk as acceptable and within the risk appetite of the company and let it happen.

For every risk decision, the recommendation must be documented along with (if applicable) the plan for action and to amend any controls, policies, and procedures. Any of these four risk decisions are acceptable outcomes to the risk assessment and risk prioritization as long as the decisions are based on the risk appetite and tolerance ranges for the company. The CRO is responsible for reporting and communication to the board of directors, providing transparency into the risk management processes and the documented decisions on risk taking and risk management.

Assessment of Risk Exposure and Risk Reporting

Managing risk is an ongoing ERM activity, operating at all levels within the organization. Regular reports from each business unit to the risk governance team should contain key risk indicators and risk metrics, which will give the risk governance team all the elements of transparency required for ongoing communication of risk management.

The CRO is responsible for selecting the risk metrics for reports to the board of directors, so they will have everything they need to perform their responsibility for ultimate decision-making for the risk management program.

Part II of the ORSA manual gives guidance on how the ORSA summary report should be documented. It emphasizes providing a high level summary of the quantitative and/or qualitative assessments of risk exposure in both normal and stressed environments for each substantive risk category from the company's risk assessment. The guidance manual highlights some elements that regulators will expect to see in the ORSA report:

- "The likelihood and impact that each material and relevant risk will have on the firm's balance sheet, income statement and future cash flows.
- Methods for determining the impact on future financial position, which may include simple stress tests or more complex stochastic analyses.
- The evaluation of each risk analysis when viewed in both normal and stressed environments.
- Risk assessments that consider the impact of stresses on capital, which may include consideration of risk capital requirements, available capital, as well as regulatory, economic, rating agency and/or other views of capital requirements.
- Documentation that the analysis is conducted in a manner consistent with the way in which the business is managed, whether on a group, legal entity, or holding company basis." [5]

Aggregate Risk

Part III of the ORSA manual gives guidance to insurers who are part of an insurer group or holding company. Group assessment of risk capital is evaluated by comparison of aggregate available capital against all substantive risks that may adversely affect the enterprise. The ERM program for an insurer that is part of a group of insurers (or part of a holding company with insurer and non-insurer affiliates) must take into account all the risks of the entire enterprise. The manual establishes the expectation that insurers have an integrated ERM framework and decision-making culture within which risk reports are fed up to the higher entity and the group assessment of available capital is evaluated and integrated into its capital management activities.

The ORSA Guidance Manual provides ideas on how an insurer may assess risk capital, including through metrics and future forecasting periods, and reflecting varying time horizons, valuation approaches, and capital management strategies. The guidance gives some specific considerations for the approach to and assessment of group-wide capital adequacy:

- "Elimination of intra-group transactions and double-gearing where the same capital is used simultaneously as a buffer against risk in two or more entities;
- The level of leverage, if any, resulting from holding company debt;
- Diversification credits and restrictions on the fungibility of capital within the holding company system, including the availability and transferability of surplus resources created by holding company system level diversification benefits;
- The effects of contagion risk, concentration risk and complexity risk in the group assessment of risk capital; and
- The effect of liquidity risk, or calls on the insurer's cash position, due to microeconomic m factors (i.e., internal operational) and/or macroeconomic factors (i.e., economic shifts)." [6]

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[5] Ibid.

[6] Ibid.

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Group Assessment of Risk Capital and Prospective Solvency Assessment

Prospective solvency assessment is the final element in Part III of the ORSA Guidance Manual. It emphasizes that the process of capital assessment by the insurer must be embedded into the overall strategic business plan of the holding company or the group of insurers.

Again, the guidance states that the goal of the assessment is to "provide an overall determination of risk capital needs for the insurer, based upon the nature, scale and complexity of risk within the group and its risk appetite, and to compare that risk capital to available capital to assess capital adequacy. It says that the insurer is required to have a robust capital forecasting capability, which supports its overall ERM framework, its time horizon for risk management and its risk appetite statement."[7]

Summary

Implementation of the ERM framework in compliance with ORSA will (1) give your management a more accurate way to evaluate material risks that might trigger insolvency; (2) potentially reduce the number of future risk-based examinations; and provide a well-documented ERM program and ORSA report, which will ultimately (3) mitigate and prevent future exam findings. ■

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[7] Ibid.

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