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ORSA is Here – Are You Ready?

Session 604
Today’s Agenda

- Introductions
- Enterprise Risk Management (ERM)
- NAIC’s Own Risk and Solvency Assessment (ORSA)
- Questions and Discussion
Introduction

- Enterprise risk management (ERM) has attracted much attention in the last several years, particularly following the great global financial crisis. In today’s uncertain world of complex and interrelated risks, an increasing number of financial institutions, including insurance companies, have implemented or are developing an ERM system.

- The accurate and deeper understanding of the extent and composition of risk-taking and the greater risk control gained by ERM can deliver significant strategic advantages. These advantages can be translated as increased efficiencies and ultimately as important tangibles as reduced earnings volatility, stronger capital position and higher profitability.
Introduction

- External institutional pressures, particularly from the regulatory community, have also been driving ERM implementation. The regulators’ intent is to foster an effective level of risk management at the enterprise (group) level for all insurers. Other external factors for ERM adoption originate from the market whose signals are expressed through the stock market and credit ratings agencies, which have added ERM as a criterion in their credit analysis and their overall assessment of insurance companies’ financial strength.

- During 2011, the Group Solvency Issues (E) Working Group determined that ERM, as well as ORSA (Own Risk and Solvency Assessment) requirements, were appropriate and beneficial for inclusion in the U.S. solvency framework. In 2012, the NAIC ORSA Guidance Manual and the Risk Management and ORSA Model Act (Model #505) was adopted.
What is ERM?

Strategic approach to managing risks and opportunities for your organization

- Proactive instead of reactive
- Encompasses multiple areas of risks and opportunities
- Requires organization-wide participation
- Ongoing process
What is ERM?

ERM Process involves

- **Identifying:**
  - Risk and Opportunities, and
  - Potential Impact and Likelihood of Occurrence

- **Determining Risk Tolerance**

- **Developing:**
  - Appropriate Responses to Risks and Opportunities, and
  - Ongoing Monitoring Process

- **Defining Terminology & Taxonomy is paramount to the process**
Risks and Opportunities

- Identifying and managing multiple and cross-enterprise risks
  - Every enterprise faces a myriad of risks affecting different parts of the organization, and enterprise risk management facilitates effective response to the interrelated impacts, and integrated responses to multiple risks
  - A brainstorming session provides an effective starting point in compiling a list of significant risks
  - Some companies prefer to start with a comprehensive but generic list of risks. The company should aim to select its own list by considering the following criteria:
    - Relevance to the insurer’s activities
    - Impact on the insurer’s financial condition
    - Ability to manage separately from other risks
Most risks can be classified into one of several categories:

### Risk and Opportunity Categories (COSO) example

**Reporting**
- Internal Controls
- Fraud Prevention/Detection
- Integrity of Financial Reporting

**Operational**
- Tone at the Top
- Program Quality
- Governance Policies

**Strategic**
- Reputation
- Business Interruption
- Leadership Succession

**Compliance**
- Economy
- Federal and State Legislative Policies
Risks and Opportunities

Categories are not static, and should be customized for insurers.

- For example:
  - Underwriting / Insurance
  - Market
  - Operational
  - Credit
  - Liquidity
Potential Impact and Likelihood of Occurrence

- For identified risks and opportunities, determine:
  - Potential Impact to Organization
  - Likelihood of Occurrence
- Organize identified risks using a matrix
Potential Impact and Likelihood of Occurrence

- **High/High**
  - Critical; requires response and frequent monitoring

- **High/Low**
  - Weigh cost/benefit of response and monitoring time

- **Low/Low**
  - Insignificant; annual review
Potential Impact and Likelihood of Occurrence

Example Risk A
Absence of Board Governance

Impact: High
Governance policies are disclosed in Form 990 (public document)

Likelihood: Low
Organization has policies and monitoring procedures in place that are consistent with not-for-profit best practices
Potential Impact and Likelihood of Occurrence

Example Risk B
Internal Controls over Wire Transfers

Impact: **High**
The organization uses wire transfers regularly in the course of business

Likelihood: **High**
One person can initiate and approve their own wire transfer; no dollar limit on the amount; no documents of wire approvals
Risk Tolerance

Risk Tolerance (a/k/a risk appetite) is the amount of risk exposure, or potential adverse impact from an event, that an organization is willing to accept.

- When determining Risk Tolerance for identified risks, ask:
  - What requires our immediate attention (High/High)?
  - Where else should we allocate time and resources to minimize risk exposure or maximize opportunities (High/Low)?
  - Which risks can the organization accept/absorb?

- Sometimes risk appetite is used interchangeably with risk tolerance, but more often, risk appetite is a qualitative measure of risk exposure where risk tolerance is a quantitative measure.
Own Risk and Solvency Assessment (ORSA)

- Near collapse of a non-insurance entity within a large multi-national holding company system containing U.S. insurers during the recent financial crises prompted U.S. insurance regulators to reevaluate their group supervisory framework and pay closer attention to risks created or inherent in activities outside of the regulated insurance entities.

- ORSA requires capital assessments evaluating prospective solvency to complement RBC as a financial regulatory safeguard

- ORSA is in various stages of implementation internationally (as part of Solvency II)
What is ORSA?

- Promulgated by NAIC in its *Risk Management and Own Risk and Solvency Assessment Model Act* (#505)

- A *confidential, internal* assessment…conducted by [the] insurer of the material and relevant risks associated with an insurer’s current business plan and the sufficiency of capital resources to support those risks

- A component of [an insurer’s] ERM framework, ORSA has two primary goals:
  - Foster effective ERM at all insurers
  - Provide a group-level perspective on risk and capital, as a supplement to the existing legal entity view
Who Does ORSA Apply to and When is it Effective?

- **Applies to:**
  - Individual entity’s premium is greater than $500 million and/or Insurer group’s premium is greater than $1 billion; or individual writing +$376 million and growing more than 10% over three years
  - Can be required by commissioner even if you don’t meet threshold

- **Adoption**
  - 21 States have adopted the legislation; 4 more are pending
  - The NAIC is considering certain sections of the model as accreditation requirements
ORSA Requirements

- Prospective assessment of group solvency
- Annual filing of an ORSA summary report is required
- Submission of summary report upon request
- Can reference other existing documentation
- Management discretion as to the nature, scale and complexity
- Report should generally follow the outline in the NAIC ORSA Guidance Manual
- The Commissioner shall not mandate specific testing or procedures
- Scalable
Summary Report Major Areas

- Section 1 – Description of the Insurer’s Risk Management Framework
- Section 2 – Insurer’s Assessment of Risk Exposure
- Section 3 – Group Risk Capital and Prospective Solvency Assessment

Section 1 – Description of the Insurer’s Risk Management Framework

- Provide a summary of the insurer’s ERM process
- Regulator may review (and the report may reference) supporting materials
  - Underwriting & claims policies
  - Investment policies
  - Reinsurance program
- Most aspects of section 1 of the report would not change significantly from year to year
  - Effective strategy is to incorporate other policies (which are dynamic) by reference to avoid having to update ORSA report
Section 1 – Description of the Insurer’s Risk Management Framework

- General statement that an effective ERM should be based on the five principles:
  - Risk culture and governance
  - Risk tolerance and appetite framework
  - Risk identification and prioritization
  - Risk management and controls
  - Risk reporting and communication
Section 2 - Insurer’s Assessment of Risk Exposure

- Quantitative and/or qualitative assessments of risk exposure in both normal and stressed environments for each material risk category
- Detailed descriptions and explanations of risks, assessment methods used, key assumptions and outcomes
- No risk quantification method is prescribed; should be consistent with way in which business is managed
- May include impact of stresses on capital; consider risk capital requirements, available capital, regulatory, economic, rating agency or other views of capital
- Demonstrate process for model validation, including factors considered and model calibration
Section 2 – “9 Branded Risks”

- Credit
- Legal
- Liquidity
- Market
- Operational
- Pricing/Underwriting
- Reputational
- Reserving
- Strategic
Section 2 – Examples of Other Risks

- Business interruption
- Cyber security
- Fraud & embezzlement
- Rating agency actions
- Reinsurance credit
- Terrorism
- Training
Section 3 - Group Risk Capital and Prospective Solvency Assessment

- Group risk capital assessment – test aggregate available capital to determine sufficiency to withstand various risks, individually and collectively – not a regulatory minimum amount (not RBC)

- Prospective solvency assessment – demonstrate that financial resources are available to execute multi-year business plan in accordance with risk appetite

- Capital adequacy assessment process integrated into management and decision making culture

- Projection of future financial position should include economic and regulatory capital given current risk profile, management policy, quality and level of capital, considering normal and stressed scenarios
Key Challenges & Potential Solutions

- Open ended in nature
- Embedding a coherent process with other ERM initiatives
- Calculation (projection) complexities
- Risk profile and risk appetite
- Stress and scenario testing
Calculation (Projection) Complexities

- Multi-year financial statement projections
- Insurance contract liabilities
- Assets and other balance sheet amounts
- Capital projections
- Methodologies
Stress and Scenario Testing

- Single event
- Multiple event
- Stochastic
- Deterministic
- Reverse engineering
Industry Feedback

- NAIC 2012 feedback pilot project results
- NAIC 2013 feedback pilot project results
- NAIC 2014 feedback pilot project planned
- Industry readiness survey results
- Feedback directly from pilot companies

http://www.naic.org/documents/committees_e_isftf_group_solvency_related_pilot_project_industry_feedback.pdf
ORSA Reporting

- Required summary report filing with domiciliary regulator should include:
  - Executive overview
  - Risk management framework
  - Assessment of risk exposures
  - Group assessment of risk capital and prospective solvency
ORSA Examination and Analysis

- Lead State prepares summary of its review
- Non-Lead State places significant reliance on Lead State
- New sections / procedures added to NAIC’s:
  - Financial Condition Examiners Handbook
  - Financial Analysis Handbook
ORSA Analysis Guidance

- **Section 1**
  - Make an initial assessment of the ERM of the insurer
  - Rate each of the five key principles
    - Level 0 (non-existent) to Level 5 (the insurer is on the leading edge of companies)

- **Section 2**
  - Based on your knowledge of the insurer, did they include in their ORSA a discussion of risks within each of the branded risk classifications below you consider appropriate for the insurer?

- **Section 3**
  - Final assessment is dependent upon an on-site examination where the models and other supporting documentation can be further evaluated
Section 1
• Onsite verification and testing to reach final conclusion
  • Test other areas not included in ORSA (review of practices)

Section 2
• Test Accuracy and Completeness
  • Appropriateness of Stress Scenarios (Reasonableness of Assumptions and Methods)

Section 3
• Reasonableness of Assumptions and Methods
  • Company’s Processes to Validate Suitability, Accuracy and Reliability of Models
ORSA Examination Results

- Utilization of ORSA results in remaining exam phases
- Leadership ratings mean that the examiner can place a high degree of reliance on ERM processes and controls to reduce and focus the scope of exam activities
- Examples provided of how information obtained through mature ORSA/ERM processes could be utilized to streamline remaining portions of exam
The ERM and ORSA Relationship

- A strong ERM process facilitates compliance with the ORSA Act
- The ORSA report is natural documentation of an effective ERM process
  - Emphasizes risk assessment and measurement of the insurer’s ERM framework and its outputs
  - Deliverable to Audit Committee and Board of Directors
  - Provided to regulators when requested
Thank you!

Questions?
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