

**Consultation Paper on
the Own Risk and Solvency Assessment (ORSA)
for the Solvency Modernization Initiative**

Solvency Modernization Initiative

1. The NAIC's Solvency Modernization Initiative (SMI) is a critical self-examination to update the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation.
2. While U.S. insurance solvency regulation is updated on a continual basis, the SMI will focus on key issues such as capital requirements, risk-focused surveillance (e.g. accounting, valuation, financial reporting, analysis, and examination), governance, group supervision, and reinsurance. The SMI scope includes the entire U.S. financial regulatory system and all aspects relative to the financial condition of a company; the scope is not limited to evaluation of solvency alone.
3. The initiative includes the following:
 - Articulation of the U.S. solvency framework and principles;
 - Study of other sectors' and other countries' solvency and accounting initiatives and the tools that are used and proposed;
 - Improvement to risk-based capital quantification;
 - Identification of governance principles and methodology for adherence to those principles;
 - Policy decisions about the future for U.S. statutory accounting and financial reporting;
 - Creation of a new reinsurance regulatory framework;
 - Movement to principle-based reserving for life insurance products;
 - Enhancement of group supervision.

Comment Submission

4. You should address comments in regards to the Consultation Paper to Director Christina Urias, Chair of the International Solvency (EX) Working Group, and sent to Kris DeFrain, NAIC, at kdefrain@naic.org. Comments should be submitted by **October 4, 2010**. Comment submissions may address individual or all questions in this document (highlighted in the gray boxes).

IAIS Own Risk and Solvency Assessment

5. The Own Risk and Solvency Assessment (ORSA) concept is adopted as part of the enterprise risk management (ERM) solvency requirements at the International Association of Insurance Supervisors (IAIS). The current drafts of the IAIS standards and guidance papers are attached as Appendix One; IAIS expects to adopt final documents by October 2010.
6. The IAIS defines the ORSA as an assessment the insurer makes about the adequacy of the insurer's risk management and current and likely future solvency position. The ORSA should encompass all reasonably foreseeable and relevant material risks. The insurer must determine the amount of financial resources needed based on its own risk tolerance, business plans, and demonstrate that the insurer is able to continue in business over the next few years.
7. IAIS expects insurers to implement the ORSA as part of a broader enterprise risk management framework, including the following (paraphrased) requirements:
 - a. Identify and quantify risk under a sufficiently wide range of outcomes or stresses.

- b. Document risks covered, measurement approaches, and key assumptions.
- c. Describe how risks are managed.
- d. Describe the relationship between the insurer's tolerance limits, regulatory capital requirements, economic capital, and the processes and method for monitoring risks.
- e. Have explicit investment, asset-liability management, and underwriting risk policies.
- f. Sets and utilizes a risk tolerance statement that sets out quantitative and qualitative risk tolerance levels and limits.
- g. Be responsive to changes in risk profile.

Risk Assessment Requirements: Bermuda, Canada, Switzerland, United States, and European Union

8. Insurance regulators have assessed solvency risks for years, but regulators are now introducing more formal enterprise risk management requirements for insurers and reinsurers around the world.

Bermuda

9. The Bermuda Monetary Authority (BMA) has developed a tool called the Commercial Insurer's Solvency Self Assessment (CISSA) to be effective in 2011.¹ The CISSA combines the following ERM and ORSA requirements:
- a. Must be performed annually, at a minimum, and after any significant change in risk and solvency profile.
 - b. Includes a forward-looking analysis that encompasses all material risks and the relationship between risk and the amount and quality of capital and the future solvency and liquidity positions.
 - c. Includes a report of the insurer's risk management and governance procedures.
 - d. Assesses both short- and long-term risks and determines the amount and quality of capital.
 - e. Assesses the future level of capital resources needed and reports its ability to remain solvent.
 - f. Explains and justifies the assessment by providing the methodology used, key assumptions, results of the assessment, sources of data, etc. and, if requested, demonstrates that all material risks are appropriately considered.
 - g. Passes a "Use Test" to show that the CISSA is integrated into the management process and decision making.
 - h. Includes annual certification from the Board and senior management.

The CISSA only applies to Class 4, Class 3B, and Class 3A² insurers and reinsurers, including long-term insurers, but with expectations to apply to groups in the future. The CISSA requirements could vary by company depending on the nature, scale, and complexity of risks in the business.

10. To aid analysis and comparisons between insurers, the BMA requires completion of a "CISSA Return" to summarize each insurer's self assessment in a uniform manner (Appendix Two). The BMA will then investigate the insurer's entire assessment on an as-needed basis. The CISSA Return, requiring reporting of financial information and answers to questions in risk detail, will allow development of a database to allow analysis of trends and development of benchmarks.

Canada

11. The Office of the Superintendent of Financial Institutions Canada (OSFI) has required prospective scenario testing since 1990. Today, the testing report is called the Dynamic Capital Adequacy Testing (DCAT). Insurers must file a DCAT report annually, based on the analysis and projection of trends of the insurer's capital position given its current circumstances, its recent past, and its intended business plan under a variety of future scenarios. An Appointed Actuary must perform a series of deterministic adverse scenario tests using the insurer's financial results and must certify that the

¹Bermuda Monetary Authority, Consultation Paper on Commercial Insurer's Solvency Self Assessment, June 2010.

²Bermuda Classes: Class 1 - Single parent writing related risks only; Class 2 - Multi-owner captives, agency captives and single parent captives writing not more than 20% unrelated risks; Class 3 - Rent-a-captive facilities, segregated account companies, companies writing connected business and companies writing up to 50% unrelated risks; Class 3A - Companies writing in excess of 50% unrelated risks and less than \$50 million in gross premium; Class 3B - Companies writing in excess of 50% unrelated risks and more than \$50 million in gross premium; Class 4 - Companies with a statutory capital and surplus of at least \$100 million that write excess liability or property catastrophe reinsurance businesses.



financial position of the institution is satisfactory after these scenario tests. The DCAT considers the insurer's three most significant risks and uses a 95-99% confidence level over one to five years (with P&C insurers typically using 99% over one year and life insurers typically using 95% over 5 years). OSFI does not currently require insurers to incorporate the DCAT into the insurer's risk management process. While some insurers incorporate the exercise into their risk management process, some companies view DCAT as a compliance exercise. Partly for this reason, OSFI is implementing more stress testing requirements.

12. OSFI published guidance on stress, scenario, and sensitivity testing in 2009³ to extend the use of testing beyond DCAT. Testing must:
- a. Be embedded in enterprise-wide risk management.
 - b. Be utilized in decision making, including setting the institution's risk appetite, setting exposure limits, and evaluating strategic choices in longer term business planning.
 - c. Help to detect vulnerabilities such as unidentified risk concentrations or potential interactions between types of risk that could threaten the viability of the institution.
 - d. Be a central tool for assessing liquidity risks.
 - e. Place special attention on risk mitigation, securitization and warehousing risks, risks to reputation, counterparty credit risk, and risk concentrations.

Stress testing must be documented and available for view upon request.

Switzerland

13. The Swiss Financial Market Supervisory Authority (FINMA) has a Swiss Solvency Test (SST) that incorporates risk assessment in the determination of capital requirements. In 2007 FINMA developed a Swiss Quality Assurance (SQA) process that includes a Swiss Quality Assessment Risk Management/Internal Control System Tool (RM/ICS Tool).⁴ All companies supervised in Switzerland must implement an "appropriate" system of risk management with effective internal controls. Insurers must report risks, risk accumulation, and prevention/mitigation measures, with uniformity in documentation and cross-references to the company's more detailed report. The report can be a group tool, but individual companies must report deviations from group rules.
14. The RM/ICS Tool, attached as Appendix Three, includes the following reporting:

- a. The risk management process, controls, and how risk management is imbedded in company decision making.
- b. Identification of risks.
- c. The tie of risk management to capital requirement calculations.
- d. Overall risk propensity.
- e. Contingency (business continuity) plans

United States

15. In the U.S., regulators built the enhanced risk-focused surveillance process around risk assessment and the management or mitigation of risks. In the Financial Examiners Handbook, Exhibit L identifies typical risks insurers face (e.g. credit, market, pricing, underwriting, reserving, liquidity, operational, legal, strategic, and reputation risks) and the evaluation of the effectiveness of risk mitigation and controls. Exhibit M contains information for review of an insurer's governance (e.g. board of directors, senior management, organizational structure, risk management function). The NAIC is currently drafting Exhibit V to aid the evaluation of prospective risk assessment (e.g. product development, strategic planning, compensation structure, and potential stresses such as rating downgrade or increased cost of capital). These exhibits are attached in Appendix Four.

³ Office of the Superintendent of Financial Institutions Canada (OSFI), Guideline E-18, December 2009

⁴ FINMA Directive BPV15/2006



16. U.S. regulators do not currently require insurers to perform ORSA-type requirements such as stress tests or the assessment of prospective financial positions; however, there are requirements for life insurers to opine that reserves make adequate provisions for anticipated cash flows and economic scenarios are utilized in the process.

European Union

17. The European Union's Solvency II Framework includes risk management requirements and an Own Risk and Solvency Assessment (ORSA) with implementation estimated for late 2012 or early 2013. The ORSA will be an assessment of the insurer's risks, the insurer's determination of their capital needs based on their risk assessment, and an analysis to show that regulatory capital requirements can be met "continuously." ORSA requirements will vary by company depending on the nature, scale, and complexity of risks in the business. Methods can range from simple stress tests to more or less sophisticated economic capital models. Insurers must show the ORSA as integrated into business strategy and decision making. The ORSA must be performed annually and after any significant change in risk and solvency profile and must include the following:
- a. Identification and assessment of the present or future risks in the short and long term (for the business planning horizon – 3 or 5 years) and of risk mitigation, considering the effectiveness of risk mitigation under a stress situation.
 - b. The continuous overall solvency needs going forward, accounting for the insurer's specific risk profile, tolerance limits, and business strategy and back-tests of previous solvency assessments.
 - c. Compliance with regulatory capital and valuation requirements. (Note that valuation, accounting, risk measure (e.g. VaR), time horizon can be different in the ORSA, but the assessment must also be performed in compliance with Solvency II requirements.) Deviations of the risk profile from that underlying the highest level of capital requirements must be justified.
 - d. Demonstration of the methods used in the assessment.
 - e. Potential management actions, including contingency planning and strategies to raise capital if needed.
 - f. External factors such as economic conditions, legal environment, technical developments, etc.
18. The insurer must document the ORSA policy and process within the broader risk management written policy and must include information about stress tests, assumptions used and the sensitivity of those assumptions, data sources, data quality assessments, and internal reporting. Insurers should internally document and regularly obtain independent ORSA assessments performed by an independent employee or consultant. For most companies, the supervisory report will be shorter than the full ORSA and will note the findings, conclusions, and quantitative outcome of each ORSA performed.

Future U.S. ORSA/ERM

19. Insurers, large and small, are increasingly performing more quantitative and qualitative risk assessments. Large companies are implementing enterprise risk management systems which include complex risk assessment. As rating agencies begin to require ERM and ORSA-type reporting, many expect expansion of these practices.⁵
20. Regulators need to decide how to best leverage the company processes and practices, to comply with IAIS standards for both legal entity and group supervision, and to achieve efficiencies in the risk management portion of risk-focused surveillance.
21. While the IAIS establishes principles, examples of the ORSA/ERM tools under development and implemented in some other jurisdictions provide some ideas for a U.S. ORSA/ERM tool.

Frequency & Confidentiality

22. U.S. regulators could tie an ORSA requirement to the risk-focused surveillance process, thereby providing a basis for discussion and increased efficiency in financial examinations. Regulators could also use an ORSA in the financial

⁵ Standard and Poors: <http://www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245214292311>

Fitch: http://www.fitchratings.com/creditrisk/reports/report_frame.cfm?rpt_id=493126

A.M. Best: <http://www.ambest.com/ratings/methodology/bcrm.pdf>

analysis process, to identify risk issues that deserve further exploration. Frequency and confidentiality issues could drive where this tool fits within the U.S. financial regulatory framework.

23. Confidentiality can be fully achieved in the financial examination process. Implementation of an ORSA in financial examination would require reporting every 5 years, at a minimum, but more often for companies that are having financial difficulty. When companies experience a significant change in risk profile (including mergers) prior to regularly scheduled examinations, regulators could call a limited scope exam to utilize confidentiality provisions in order to view an updated ORSA.
24. Regulators could require annual reporting for an ORSA that is implemented for financial analysis and at each major change to the risk profile. Given the proprietary nature of the information contemplated for this tool (e.g. risk appetite, prospective business plans, etc.), regulators would need a solution to achieve confidentiality for these filings in states that do not already have confidentiality statutes for financial analysis work.

Scope: Groups/Legal Entity/ Pools

25. The draft Model Law #440 – Insurance Holding Company System Regulatory Act includes an annual reporting provision that the ultimate controlling person, to the best of their knowledge and belief, identify the material risks within the insurance holding company system that could pose enterprise risk (e.g. financial and/or reputational contagion) to the insurer.
26. Insurance companies typically perform their risk management at the group level or at the legal entity level for stand-alone companies. Numerous parties have suggested that insures should report the ERM/ORSA tool just as it is performed in the way the group manages its business.

Proportionality

27. International requirements include the proportionality principle, so that requirements vary depending on the nature, scale, and complexity of risk.

Questions:

1)

A. Content: What content should be included in the ORSA/ERM tool about **RISK MANAGEMENT?**

Risk and Risk Management “Description”

- a. Description of risk management and the process used to assess, monitor, and communicate risk.
Explanation of how (or if) the report and its results ties to a company’s management of the business.
Note: Whether the report is required to tie to the company’s management is identified as a topic for future decision.
- b. Risk appetite, tolerances, and/or limits
- c. Identification of significant risks faced by the insurer
(underwriting, marketing, credit, investment, catastrophe, operational – including disaster recovery/business continuity risks, contagion, reputation, liquidity – including asset-liability management and cash flow and market value volatility, legal, reinsurance, reserving, concentration, and operational risk.)
- d. Identification of emerging risks
- e. New actions taken by the company that will impact the risk profile.
- f.1. Recent changes that have occurred to the risk profile.
- f.2. Risk Mitigation description – reinsurance, securitization, pooling, etc.
- g. Contingency plans (actions the company expects to take under different circumstances).

Risk “Quantitative”

- h. Quantification/Assessment of each significant risk, assumptions used, sensitivity of assumptions, changes made to assumptions and the impact of such, etc.
- i. Forward-looking Stress Testing, Description and Results
- j. Forward-looking Scenario Testing, Description and Results
- k. Trends
- l. Documentation of any internal models used (e.g. overview of model, impact of significant assumptions)
- m.1. Identification of any insurers in the group that have triggered an RBC action or control level and how that is considered in the insurer's risk management.

Risk and Risk Management "Other?"

- m.2. Are there any other risk/risk management items that should be included?

B. Content: What should be included in the ORSA/ERM tool about SOLVENCY ASSESSMENT?

- aa. A company's view of the short- and long-term significant risks and the amount of funds necessary to cover them. ("Short- and long-term" would require definition).
 - bb. Upon reflection of the significant risks the company identifies, does the company believe the RBC is too low?
 - cc. Prospective (forward-looking) solvency assessment to attest to the ability to maintain a going concern.
 - Qualitative assessment
 - Quantitative calculations
 - dd. The company's own target capital
 - ee. Explanation and documentation of the internal models used by the company, including the extent of reliance on outside models.
 - ff. Description of the reflection of significant interrelationships between risks and diversification effects considered.
 - gg. Basis for the calculations (e.g. economic valuation)
 - hh. Other solvency assessment?
- 2) Frequency: How often should the insurer perform this process (e.g. quarterly, annually, prior to financial examinations, when there is a significant change in the risk profile of a company)? How often should the insurer report on this process?
 - 3) Confidentiality: How should confidentiality be maintained (e.g. through examination process or via a new law/regulation)? Which component(s) of the content identified in #1 is not proprietary and could be made public?
 - 4) Group / Legal Entity / Pool: At what level should regulators require this tool (e.g. group, legal entity, intercompany pool)? Should the tool be required based upon "how the enterprise is managed"?
 - a. How should non-insurance entities be considered?
 - b. Should international entities be included?
 - 5) Proportionality: How should U.S. regulators implement proportionality (e.g. size, nature/scale/complexity, extent of international activity, certain lines of business, etc.)? What exclusions from the requirements or simplified reporting would you recommend, and for whom?

Uniformity/Specificity

28. All countries are implementing this tool with focus on the insurer's own risk management and solvency assessment process. Some countries require insurers to tie the company's own process to their regulatory process. And some countries utilize a minimum level of uniform reporting, or standardized cross-referencing to the company's full report, to aid the regulator's review.
29. In order for the company to show that their ORSA/ERM ties to their strategic planning and business activities, regulators should limit specificity of requirements; however, it may be necessary for regulators to establish some specific stress and scenario tests.

Questions:

- 6) Should the U.S. implement a questionnaire or a minimum level of standardized reporting? If so, should the reporting be an abbreviated reporting, with the full report available for review at the company upon request? Should a "sample report" or template be provided for educational purposes?
- 7) Should the tool be entirely driven by the company or should the regulators specify items such as specific stress tests or safety levels?
- a) If regulators specify stress or scenario tests, what should be the focus of the tests (e.g. major interest rate shift, major changes in lapse rates, misestimation of parameters, large adverse development in loss reserves (including adverse court decisions, etc.)?
 - b) If regulators specify a safety level (e.g. 99.0% TVar) and time horizon for solvency assessment, what should those be?

Certification

30. A need for certification would depend on the content of the tool, as well as the regulators' desire for a company representative or consultant to take ownership of the product.
31. The U.S. system currently requires actuarial certification in some instances, given their professional examinations and professional standards. There are also risk professional certifications which require successful completion of examination (e.g. Chartered Enterprise Risk Analyst (CERA), Financial Risk Manager (FRM), and Professional Risk Manager (PRM)). We would need to study whether these certifications require specified professional standards if we elect to require such professional certification.

Questions:

- 8) Should the Board be responsible for the ORSA/ERM? If so, to what extent? Should there be a sign off or certification requirement (by an actuary, chief risk officer, risk professional)? Should there be a required report to the Board (e.g. on stress tests)?

Regulatory Resources

32. With the changes to the enhanced risk-focused surveillance process and introduction of this new tool, there may be a need for new regulatory skills and resources in the area of risk management, raising the question as to whether each state needs to have resources on staff, hire consultants, or create shared or “central risk resources.”

Questions:

- 9) How great will the need be for additional resources? Do states need to hire more risk experts? Do they need these experts on staff, or should they hire consults or share resources?

What’s in a Name?

33. “ORSA” stands for “Own Risk and Solvency Assessment.” Depending on the content of the tool, another name might be more appropriate, considering some tests are not about “solvency,” but about “shareholder value” and some uniformity or specificity might negate the “own” in the name.

Questions:

- 10) What should we name this tool?

Other Related Topics

34. Some issues will remain about the overall risk management framework to be incorporated into U.S. regulatory requirements. Remaining risk management issues include, but are not limited to, the following:
- Mechanism for requirements for ERM, including a decision as to whether an insurer should adopt a formal risk management framework/function.
 - Regulatory powers related to ERM.
 - Responsibilities of the Board and Senior Management.
 - Required tie of risk management reporting to insurance company operations and strategic management.

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