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◆ INTRODUCTION

Aligning insurance supervision with insurance business practice, insurance regulators across the globe have been working toward a common goal of improving the processes for understanding and measuring risks inherent in the business of insurance. The International Association of Insurance Supervisors (IAIS) is promoting a concept called Own Risk and Solvency Assessment (ORSA) as a key component of regulatory reform. An ORSA will require insurance companies to issue their own assessment of their current and future risk through an internal risk self-assessment process and it will allow regulators to form an enhanced view of an insurer's ability to withstand financial stress.

The ORSA concept is now embedded in the IAIS standards and is in various stages of implementation in the United States, Europe and other jurisdictions. Resulting from the NAIC Solvency Modernization Initiative (SMI), large- and medium-size U.S. insurance groups and/or insurers will be required to regularly conduct an ORSA starting in 2015. Solvency II, the regulatory regime that is being implemented in Europe, will require nearly all European Union-domiciled insurers to be subject to Solvency II requirements once it becomes effective in the next few years. An ORSA is a key part of Solvency II. The Australian Prudential Regulatory Authority (APRA) will require life and property/casualty insurers to have an Internal Capital Adequacy Assessment (ICAAP), which is similar to Solvency II's ORSA, in place by Jan. 1, 2013. Other jurisdictions—including Japan, Canada, Bermuda and Switzerland—are implementing similar changes.¹

While the overall concept of ORSA is similar among jurisdictions, specific definitions and requirements differ by country. This article will discuss the purpose and general characteristics of an ORSA and summarize some of the major policy developments in the United States. The article will also contrast how the U.S. ORSA initiative compares to the ORSA under development in the European Union (EU).

◆ ORSA: WHAT IS IT?

In essence, an ORSA is an internal process undertaken by an insurer or insurance group to assess the adequacy of its risk management and current and prospective solvency positions under normal and severe stress scenarios. An ORSA will require insurers to analyze all reasonably foreseeable and relevant material risks (i.e., underwriting,

WHAT IS AN ORSA?

- A continuous process
- Determined by firm (i.e., "own")
- Short- and long-term risk
- Qualitative and quantitative
- Overall solvency needs
- Adequacy of regulatory capital

credit, market, operational, liquidity risks, etc.) that could have an impact on an insurer's ability to meet its policyholder obligations.

The "O" in ORSA represents the insurer's "own" assessment of their current and future risks. Insurers and/or insurance groups will be required to articulate their own judgment about risk management and the adequacy of their capital position. This is meant to encourage management to anticipate potential capital needs, and to take action before it's too late. ORSA is not a one-off exercise; it is a continuous process and should be a fundamental part of the risk-management system for an insurer. Moreover, there is no mechanical way of conducting an ORSA; how to conduct the ORSA is left to each insurer to decide, and actual results and contents of an ORSA report will vary from company to company. The output will be a set of documents that demonstrate the results of management's self-assessment.

◆ ORIGIN OF ORSA

The origin of the term ORSA can be traced to insurance sector reforms introduced by the Financial Services Authority (FSA), the United Kingdom's financial regulatory agency. In response to a rash of insolvencies, the FSA developed a new solvency framework in the early 2000s, and implemented it in approximately 2004. Many of the FSA reforms were designed to ensure that insurers have enough capital to cover potential risks. According to the FSA, the overall aim of the reforms were to reduce "the probability of prudential failure, in a cost-efficient way that creates greater transparency in the arrangements for setting regulatory capital levels, while at the same time promoting a strong culture of risk management."²

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¹ Shapella, Anthony and Stein, Owen, "Understanding ORSA Before Implementing It," Society of Actuaries, 2012.

² New capital standards 'to reduce risk of failure,' May 9, 2002. Retrieved at: www.fsa.gov.uk/library/communication/pr/2002/050.shtml

One of the FSA reforms required firms to develop internal models to analyze their overall risk position. In 2005, the FSA implemented the Individual Capital Adequacy Standards (ICAS). ICAS required insurers to undertake a risk-based capital assessment to better understand their risk profile and to improve policyholder protection. ICAS is essentially a firm's assessment of its own risk profile in order to determine the level of capital required to mitigate the specific risks inherent in their business. To integrate the ICAS into the operations of the business and broaden it from more of a compliance exercise to an internal assessment process "owned" by the insurer, the FSA developed the concept of an Own Risk and Capital Assessment that was based on the ICAS concept.

The ICAS regime will be replaced by Solvency II, which was initiated in 2000 by the European Commission to implement a fundamental change to European insurance regulation. Solvency II builds on the Own Risk and Capital Assessment framework; changing the "C" (capital) to "S" (solvency) to make it more consistent with the named reforms (Solvency II).³ Solvency II aims to create a more harmonized, risk-orientated solvency regime, resulting in capital requirements that are more reflective of current and future business risks. A key feature is the requirement that all firms undertake an ORSA to demonstrate "sound and prudent management of the business" and assess overall solvency needs.

In 2010, the ORSA concept was adopted as part of the IAIS Insurance Core Principles (ICPs). The IAIS adopted 26 revised ICPs in October 2010 to accommodate new approaches to insurance supervision, including the adoption of ICP 16—Enterprise Risk Management (ERM). ICP 16 says an insurer should perform an ORSA to regularly assess the adequacy of its risk management in supporting the current, and the expected future, solvency positions. ICP 16 applies to "insurance legal entities and insurance groups with regard to the risks posed to them by non-insurance entities."⁴

As a result, an ORSA is now a worldwide standard. In order to comply with the ICPs, all IAIS members are asked to apply ICP 16 in their legal frameworks and supervisory practices. Moreover, the ICPs are used by the International Monetary Fund (IMF) and World Bank in the Financial Sector Assessment Program (FSAP) review. Conducted worldwide, the FSAP is designed to address financial sector stability issues through an evaluation of the regulatory rules and practices measured against the internationally recognized

standards and codes. For insurance, the ICPs form the basis for the assessment of regulators' observance of international standards.

A key difference between ORSA and the ICAS predecessor is that ORSA includes qualitative assessments of the insurer's governance, whereas the ICAS focused mainly on the firm's quantitative capital requirements.⁵ Under ICAS, firms were required to undertake regular assessments of the amount and quality of capital adequate for its size and nature of business (its ICA). In contrast, an ORSA includes quantitative requirements for measuring financial position, as well as a review of risk-management practices. In addition, ORSA results lead to actual company action plans. According to ICP 16.11.1, "Every insurer should undertake its ORSA and document the rationale, calculations and **action plans** arising from this assessment."

Moreover, to address concerns arising from the global financial crisis and American International Group intervention, ORSA reaches beyond the regulated insurance entity and includes risk affecting the insurance group, even where the affiliates are not insurance entities. According to ICP 16.13, the insurer's ORSA should encompass all reasonably foreseeable and relevant material risks, as well as risks arising due to membership of a group.

◆ NAIC U.S. ORSA

In light of the recent financial crisis, U.S. insurance regulators began to modify their supervisory framework. In 2008, the NAIC launched the Solvency Modernization Initiative—a critical self-examination to update the U.S. insurance solvency framework. SMI focuses on key issues such as capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance. As part of the SMI, the NAIC re-evaluated risk-based capital (RBC) in the United States and determined that RBC will continue to form the backstop function for insurer solvency to: (1) guarantee regulator action; and (2) provide the legal authority to intervene without extensive litigation.

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³ Blanchard, Ralph, "The Latest on ORSA," *Actuarial Review*, Casualty Actuarial Society, August 2012.

⁴ IAIS Insurance Core Principle (ICP) material adopted October 2010. Retrieved at: www.iaisweb.org/__temp/ICP_16_Enterprise_Risk_Management_standards_and_guidance_material.pdf

⁵ Blanchard, Ralph, "The Latest on ORSA," *Actuarial Review*, Casualty Actuarial Society, August 2012.

Regulators decided that additional capital assessments evaluating prospective solvency should be added to the system. Additional capital assessments will be included in ORSA to complement RBC as a financial regulatory safeguard. The *NAIC ORSA Guidance Manual*, which was adopted by the NAIC Executive (EX) Committee and Plenary in March 2012, provides information for insurers on performing its ORSA and documenting risk policies and procedures.

Pursuant to the *NAIC ORSA Guidance Manual* and the newly adopted Risk Management and Own Risk and Solvency Assessment Model Act (#505), an insurer and/or the insurance group of which the insurer is a member will be required to complete an ORSA “at least annually to assess the adequacy of its risk management and current, and likely future, solvency position.” The ORSA will apply to any individual U.S. insurer that writes more than \$500 million of annual direct written and assumed premium, and/or insurance groups that collectively write more than \$1 billion of annual direct written and assumed premium.

While the *NAIC ORSA Guidance Manual* is deliberately non-prescriptive, because each ORSA will be unique and will vary depending on risks that are unique to that insurer/group, insurers subject to the ORSA requirements are instructed to examine their own risk profile in three major sections. Section 1 – Description of the Insurer’s Risk Management Framework, should be a high-level summary of its own risk-management framework, including risk appetite, tolerance and limits and internal controls. Section 2 – Insurer’s Assessment of Risk Exposure, should include detail showing the insurers’ process for assessing risks (both qualitative and quantitative assessments should be performed) in both normal and stressed environments. Section 3 – Group Risk Capital and Prospective Solvency Assessment, should demonstrate that current and future capital is sufficient to support the identified risks.

Companies must keep the ORSA up-to-date through an annual update and review. All foreseeable and materials risks should be included in the assessment. Insurers will need to develop processes to perform a self-assessment in the stressed environment using either a stress test methodology or stochastic model.

To avoid duplicative international regulatory requirements, an internationally active insurer may be able to satisfy the ORSA filing requirements, or sections, by providing the most recent and substantially similar report provided by the in-

surer or another member of an insurance group, of which the insurer is a member, to a supervisor or regulator of a non-U.S. jurisdiction.

When the NAIC Executive (EX) Committee and Plenary adopted Model #505 on Sept. 12, 2012, it was expected that each jurisdiction would adopt risk-management and ORSA requirements into state law prior to 2015. Model #505 provides the requirements for completing an annual ORSA and provides guidance and instructions for filing an ORSA Summary Report.

According to Model #505, the ORSA Summary Report should demonstrate that each entity’s capital—both regulatory and economic—is sufficient to cover the risks inherent in the entity’s business plan. If the insurer does not have the necessary capital to meet its current or projected risk capital requirement, then it should describe the management actions it has taken (or will take) to remediate any capital adequacy concerns.

In July 2012, the NAIC ORSA (E) Subgroup completed an ORSA Feedback Pilot Project. The project was a review of confidential ORSA Summary Reports from 14 volunteer insurance groups. The goal of the project was to provide feedback to the industry, identify revisions to the *NAIC ORSA Guidance Manual*, and identify areas to develop guidance for regulators. The project also served to help guide the development of enterprise risk management education materials for state insurance regulators. Based on the ORSA (E) Subgroup’s observations, they will evaluate the need for revisions to the *NAIC ORSA Guidance Manual* and finalize a pilot project report with key observations that will be made available to the public. The pilot program is expected to be repeated in 2013.

◆ HOW ORSA FITS INTO THE U.S. SOLVENCY SYSTEM

A cornerstone of the U.S. solvency system is the risk-focused surveillance process. In this process, the regulator studies and reports on an insurer’s financial condition, focusing on residual risks (not sufficiently mitigated through controls) in the insurer’s overall operations. The residual risks are determined after regulators obtain an understanding of the insurer’s overall operations, inherent risks and risk-mitigation strategies/controls. Regulators recently enhanced the risk-focused surveillance to better incorporate prospective risk assessment in identifying insurers that have, or will encounter, solvency issues and bring focus to the broader issues of the ability of management to identify, assess and manage

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the business risks of the insurer. An ORSA will fit readily into this process.

The information an ORSA contains will supplement the risk-focused examination process and provide regulators with a more dynamic view of each company's risk profile. The *NAIC ORSA Guidance Manual* notes that the depth and breadth of the insurer's risk-focused examination will hinge on the contents and discussions surrounding the ORSA Summary Report. As noted earlier, the ORSA Summary Report should include three major sections. Section 1 documents the company's risk-management framework, while Section 2 documents the insurer assessment of risk exposures. In the risk-focused surveillance process, regulators currently perform certain elements of risk-management evaluation, which includes an assessment of risk and the insurer's ability to manage or mitigate risks. As part of the enhanced risk-focused surveillance process, U.S. insurers are required to detail the risks they face and how they mitigate those risks. Section 1 and Section 2 of the ORSA Summary Report create a formalized risk-management reporting and quantification requirement in the enhanced risk-focused surveillance process.

Section 3 of the ORSA Summary Report documents how the company combines the qualitative elements of its risk-management policy and the quantitative measures of risk exposure in determining the level of financial resources it needs to manage its current business and its longer-term business. For U.S. regulators, RBC models are among multiple tools available to evaluate an insurer's ability to fulfill its obligations to policyholders. The NAIC RBC system was adopted by most of the states in the 1990s in order to "provide a capital adequacy standard that is related to risk, raises a safety net for insurers, is uniform among the states, and provides regulatory authority for timely action." A separate RBC formula exists for each of the primary insurance types: life, property/casualty, health and fraternal.

RBC provides a legal-entity view of required capital and a group capital view in some situations (e.g., for parent insurance companies), whereas the ORSA will more often provide a group view of capital. An ORSA will also enhance regulators' ability to determine an insurer's prospective solvency position and understand actual, projected and target levels of risk capital in excess of the required regulatory minimum levels. This will allow regulators to key in on each insurer's top risks more efficiently and allocate resources to the most critical areas for regulatory review. It is important to note that, while the ORSA forms part of the supervisory

process, it does not create an additional capital requirement; rather, it allows for extensive regulatory assessment of the group capital position.

◆ ORSA: KEY DIFFERENCES AMONG THE U.S. AND EU

The scope and general purpose of an ORSA is relatively similar across jurisdictions. The concept supports a robust company risk-management framework and the approaches are not rules-based or static formula-based. However, while there are similarities, the two approaches are not identical. The following summarizes some of the key differences between the U.S. ORSA and EU Solvency II ORSA.

Management/Board: Currently, the U.S. ORSA and the Solvency II ORSA require a different degree of involvement of management in the ORSA process. The European Insurance and Occupational Pensions Authority (EIOPA) Chairperson Gabriel Bernardino has noted that ORSA changes the viewing angle from bottom-up to top-down and that ORSA will change the way boards of directors approach the risk- and capital-management processes.⁶ In the EU ORSA consultation paper, it states that "The undertaking should ensure that its administrative, management or supervisory body takes an active part in the ORSA process by steering how the assessment is performed and challenging its results."⁷

The *NAIC ORSA Guidance Manual* requires the management board to decide on the adequacy of the firm's ERM system and capital, based on their own assessment of the firm's future plans, risk and risk capacity. However, the *NAIC ORSA Guidance Manual* does not clearly define or distinguish the role and responsibilities of the board of directors and senior management for the holistic ERM processes.

Proportionality and Exemptions: In the EU, all (re)insurers with gross premium income exceeding €5 million are subject to Solvency II.⁸ All EU-domiciled insurers in this threshold, including small insurers, will be subject to an ORSA requirement.

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⁶ Eom, Seong-Min, "U.S. ORSA Developments," *Life Actuarial Insights*, KPMG, October 2011.

⁷ EIOPA Final Report on the Public Consultation Paper On the Proposal for Guidelines on Own Risk and Solvency Assessment (CP-11/008), July 12, 2012.

⁸ FSA website, Information for Firms, Solvency II. Retrieved from: www.fsa.gov.uk/smallfirms/your_firm_type/insurers/solvency.shtml

ORSA IS ON ITS WAY (CONTINUED)

EU SOLVENCY II ORSA AND U.S. ORSA — KEY DIFFERENCES		
	European Union	United States
Management/Board	Role and responsibilities of board of directors and senior management defined.	Role and responsibilities of board of directors and senior management under discussion.
Proportionality	All (re)insurers subject to Solvency II	Group > \$1B or entity > \$500M (all others have significant financial reporting deemed proportionate)
Legal Entity and Group Reporting	Both legal entity and group	Based on how a company manages its risks (legal entity, subgroup, enterprise)

In the United States, insurance groups will be exempted from the ORSA requirement if their premium income writing is less than \$1 billion per year, as well as individual insurers with less than \$500 million in annual premium. This is expected to capture at least 80% of the U.S. insurance market, while relieving a large number of smaller insurers from the ORSA requirement. In addition, an insurer may make an application to the domiciliary commissioner for a waiver from the requirements of the ORSA based on unique circumstances. U.S. regulators consider the extensive financial reporting requirements to effectively be a proportionate “mini ORSA” for smaller insurers.

Legal Entity and Group Reporting: Under Solvency II, both the legal entity and the group will be required to perform an ORSA.⁹ In the United States, an insurer, or the insurance group to which the insurer is a member, is required to perform an ORSA for “however a company/group manages its business,” which could be legal entity, a subgroup of entities in the group or the group as a whole. U.S. regulators view the ORSA as reporting of business practice and, thus, want the reporting to reflect how the business is actually managed for risk-management purposes.

Regulatory Action: Actions regulators will take based on information in the ORSA is unclear. If a company reports in their ORSA that their available capital is insufficient to meet its prospective capital needs, U.S. regulatory action

could range from additional scrutiny during the regulatory process to public reports detailing the inadequacy of the firm’s risk-management practices. If a company reports in their ORSA that there are risks not contemplated in their regulatory requirements, under Solvency II, an additional capital requirement may be assessed,¹⁰ while the NAIC would consider the issue in the assessment of the overall financial condition.

◆ SUMMARY

An ORSA will help regulators better understand the prospective risks to each insurer’s plan and judge the adequacy of capital for the risks identified. An effective ORSA can provide useful insights into the capital and efficiency of the business and management actions needed in the future. It will enable companies to evaluate the long-term capital efficiency of particular products and assist in the design of new policies. Regulators will use the results of the ORSA to form an opinion of an insurer’s risk management and prospective solvency. This allows regulators to use the ORSA as an “early warning” device and to work with the insurance group to strengthen the insurer’s risk-management, solvency-assessment and capital-management processes where necessary.

⁹ EIOPA Final Report on the Public Consultation Paper On the Proposal for Guidelines on Own Risk and Solvency Assessment (CP-11/008), July 12, 2012.

¹⁰ European Commission, Solvency II FAQ. Retrieved from: http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/faq_en.pdf.



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