



February 11, 2011

U.S. Own Risk and Solvency Assessment (ORSA) Proposal

Comment Submission

Comments on this U.S. Own Risk and Solvency Assessment (ORSA) proposal should be addressed to Director Christina Urias, Chair of the International Solvency (EX) Working Group, and sent via e-mail to Kris DeFrain, NAIC, at kdefrain@naic.org. Comments should be submitted by **March 18, 2011**.

Introduction

1. As defined in the International Association of Insurance Supervisor (IAIS) Insurance Core Principle (ICP) 16, Enterprise Risk Management (ERM) is the process of identifying, assessing, measuring, monitoring, controlling and mitigating risks. ICP 16 applies to insurance legal entities and insurance groups with regard to risks posed to insurance legal entities by non-insurance entities within a group.
2. ERM involves the self-assessment of all reasonably foreseeable and relevant material risks and the interrelationships of risks faced by an insurer. ERM provides a link between the operational management of risk and the long-term business goals and strategies. Since ERM is primarily focused on the actions an insurer takes to manage and control risk, ERM is a rigorous discipline of enforcement of risk standards, policies and tolerance limits. In setting risk tolerance limits, the insurer must consider its current solvency position as well future solvency positions based on projected outcomes of scenarios run using a range of plausible future business assumptions which reflect sufficiently adverse scenarios.

Solvency Regime Requirements

3. ICP 16 imposes several requirements of the Solvency Regime related to ERM. The Solvency Regime must:
 - A. Require the insurer's ERM framework to provide for the identification and quantification of risk under a sufficiently wide range of outcomes using techniques which are appropriate to the nature, scale and complexity of the risks the insurer bears and adequate for capital management and solvency purposes.
 - B. Require the insurer's ERM process of risk identification and quantification to be supported by accurate documentation providing appropriately detailed descriptions and explanations of risks identified, the measurement approaches used, key assumptions made and outcomes of any plausible adverse scenarios that were run.
 - C. Require the insurer's ERM framework to include a risk management policy which:
 - Outlines how all relevant and material categories of risk are managed, both in the insurer's business strategy and its day-to-day operations.
 - Describes the relationship between the insurer's tolerance limits, regulatory capital requirements, economic capital and the processes and methods for monitoring risk.
 - Includes an explicit asset-liability management (ALM) policy which clearly specifies the nature, role and extent of ALM activities and the relationship with product development, pricing and investment management functions.
 - Includes an explicit investment policy which specifies the nature, role and extent of the insurer's investment activities, specifies how compliance with solvency regime investment requirements are performed and specifies explicit risk management procedures regarding more complex and less transparent classes of assets and investments in markets or instruments that are subject to less governance or regulation.
 - Includes explicit policies relating to underwriting risk.
 - D. Require the insurer's ERM framework to establish and maintain a risk tolerance statement setting out overall quantitative and qualitative risk tolerance levels and limits taking into account relevant and material categories of risk and risk relationships.
 - E. Require the insurer's ERM framework to use its risk tolerance levels and limits in its business strategy and its day-to-day operations via its risk management policies and procedures.



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- F. Require the insurer's ERM framework to be responsive to changes in its risk profile and to incorporate a feedback loop based on appropriate and quality information, management processes and objective assessments enabling it to take necessary action in a timely manner in response to changes in its risk profile.
- G. Charge the insurer's Board and Senior Management with the responsibility of regularly performing its Own Risk and Solvency Assessment (ORSA) to assess the adequacy of its risk management and current and likely future solvency position.
- H. Require the insurer to address as part of its ORSA all reasonably foreseeable and relevant material risks including as a minimum underwriting, credit, market, operational and liquidity risks as well as any risks associated with group membership and identifying the relationship between risk management and the level and quality of financial resources needed and available.
- I. Require the insurer to determine as part of its ORSA the overall financial resources it needs to manage its business given its risk tolerance limits and business plans and demonstrate that supervisory regime requirements are met.
- J. Require the insurer to base its risk management actions on consideration of its economic capital, regulatory capital requirements and financial resources as determined in its ORSA.
- K. Require the insurer, as part of its ORSA, to assess the quality and adequacy of its capital resources to meet regulatory capital requirements and any additional capital needs.
- L. Require the insurer, as part of its ORSA, to analyze its ability to continue in business and the risk management and financial resources required to over a longer time horizon that is typically used to determine regulatory capital requirements.
- M. Require the insurer, as part of its ORSA, to address a combination of quantitative and qualitative elements in the medium and longer-term business strategy of the insurer and include projections of its future financial position and analysis of its ability to meet future regulatory capital requirements.
- N. Require the Supervisor to undertake the review of an insurer's risk management processes, the review of the insurer's financial condition and a review of the insurer's ORSA.
- O. Require the Supervisor to take action to strengthen the insurer's risk management, solvency assessment and capital management processes where necessary.

Compliance Requirements for U.S. Companies

I. Background

- 4. Over the past 20 years, U.S. state insurance regulators and insurance companies have been working toward a common goal of improving the processes for understanding and measuring risks inherent in the business of insurance. Recent examples include the introduction of the actuarial opinion and memorandum regulation in assessing the risk of formula reserve adequacy given the assets a company holds to fund those formula reserves, the implementation of actuarial guideline 43 addressing risks inherent in variable annuities that provide guaranteed death and living benefits, updates to the risk based capital framework addressing interest rate and market risk (C-3 Phase I and II), implementation of a risk focused financial examination process and the more recent work to implement a principle-based approach to valuation of insurance risk.
- 5. The principle-based approach to the valuation of insurance risk recognizes that insurance companies are diverse in the type and amount of insurance risk they assume as well as diverse in how they go about managing and mitigating insurance risk and as a result, there is not a "one size fits all" level of reserve or capital that should be established nor is there a "one size fits all" method of managing and mitigating insurance risk.
- 6. Given the need for a holistic approach to risk management, U.S. state insurance regulators believe that each insurance company legal entity must perform an ORSA and share that assessment with the state insurance regulators. As part of the ORSA, the insurance company legal entity must document their ERM process and disclose information about the risks the insurance company legal entity is exposed to and the magnitude of those risks and provide a prospective solvency assessment based upon the impact those risks have on the insurance company legal entity. Like a disaster recovery program, companies must keep the ORSA up-to-date through an annual update and review.



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7. If an insurance company legal entity is part of a group of companies that includes other insurance and non-insurance legal entities, the ORSA needs to address any risks posed to the insurance legal entity by other insurance and non-insurance legal entities within the group due to any legal or contractual relationships between legal entities within the group.

II. Implementation Authority

8. Through state insurance statute and/or regulation, the state shall charge an insurance company's board of directors and/or senior management with conducting an annual ORSA and reporting the results of the ORSA to the state regulator. The state statute and/or regulation will address confidentiality protection of the ORSA. Such confidentiality protection will be similar to such protections granted to state insurance examinations under the state insurance examination statutes.

III. Purpose

9. The purpose of charging the company's board of directors and/or senior management with conducting an ORSA is to insure that the company has developed a risk management policy that clearly identifies material risks and the amount of material risks the company is exposed to, how the company measures the amount of material risk, how the company expects to monitor, manage and mitigate those material risks and to insure that the company has communicated the risk management policy to all company management personnel so that they understand how their actions and decisions they make in executing the company's business strategy impacts overall risk tolerance limits and economic and regulatory capital needed to continue to operate in a strong and healthy manner.
10. The ORSA will also assist the state insurance regulator in evaluating for each insurance company legal entity the amount of risk exposure and quality of the risk management processes within the insurance company legal entity thereby leading to a better allocation of regulatory resources in conducting risk focused financial examinations (frequency and depth of examination) and determining the overall financial condition of the insurance company legal entity. The ORSA will also assist U.S. insurance regulators in developing an understanding of the vital role the U.S. insurance industry plays in the U.S. economy and communicating that vital role to other domestic and international regulatory bodies.

IV. U.S. Own Risk and Solvency Assessment (ORSA) Requirements

11. While the ORSA is completed entirely by the insurance company legal entity and therefore represents their internal risk management assessment, U.S. insurance regulators believe that the resulting U.S. ORSA output document should contain three major sections as follows:
 - **Section 1** - Description of the Risk Management Policy
 - **Section 2** - Quantitative Measurements of Risk Exposure in Normal and Stressed Environments
 - **Section 3** - Prospective Solvency Assessment

Section 1 – Description of the Risk Management Policy

12. Section 1 of the ORSA shall document in complete detail the company's risk management policy which shall identify all relevant and material risk categories and describe how those risk categories are managed on a day-to-day operational basis as the company executes its business strategy. The risk management policy shall describe any processes and methods used for monitoring risk and shall include any risk tolerance statements and describe the relationship between any risk tolerance statements and capital requirements both regulatory and economic. Any risk tolerance statements shall include all quantitative and qualitative risk tolerance limits, how the tolerance statements and limits are determined, taking into account relevant and material categories of risk and risk relationships that are identified.
13. The risk management policy shall also include the company's investment policy which shall specify the nature, role and extent of the insurer's investment activities, how the investment policy complies with the solvency regime investment requirements and specifies explicit risk management procedures regarding more complex and less transparent classes of assets and investments in markets or instruments that may be subject to less governance or regulation. The investment



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policy shall address credit risk, market risk, liquidity risk and any counterparty risk that may be associated with any hedging programs. The ORSA shall provide the company's own internal analysis processes used to identify such risks and not rely exclusively on investment managers or rating agencies and their use of diversification to mitigate such risks.

14. The risk management policy shall also include any underwriting policy used by the company to manage underwriting risk and describe the relationship of the underwriting policy to product design and product pricing.
15. The risk management policy shall also include any claims underwriting or claims processing policies implemented by the company to manage any risks associated with determining whether claims are covered under the contract and how claim amounts are determined.
16. The risk management policy shall also include a description of any anti-fraud policies that have been implemented to detect fraud in filing of claims.
17. The risk management policy shall also include a description of any asset-liability management (ALM) activities which clearly specifies the nature, role and extent of ALM activities and the relationship with product development, pricing and investment management functions.
18. The risk management policy shall also include a description of any retention or conservation policy or program designed to retain assets, policies in force or market share. Such programs may include multiple coverage discounts, extra interest credits or other policyholder options.
19. The risk management policy shall also include a description of any reinsurance counterparty policy related to any reinsurance programs the company has in effect.
20. The risk management policy shall also include, if applicable, any management activities or policy related to processes of identifying, assessing, measuring, monitoring, controlling and mitigating risks associated with group membership.
21. The ORSA must also disclose how the company's management uses its risk management policy including any tolerance statements and limits in its day-to-day operations as it executes its business strategy. The ORSA must disclose company information, management processes, and assessment tools (feedback loops) used to monitor and respond to any changes in its risk profile due to economic changes, operational changes, or changes in its business strategy. The ORSA must also disclose how the risk management policy is related and tied to the determination of the amount and quality of its economic capital and regulatory capital.

Section 2 - Quantitative Measurements of Risk Exposure in Normal and Stressed Environments

22. Section 2 of the ORSA shall document the quantitative measurements of risk exposure in both normal and stressed environments for each risk category identified in Section 1. This quantitative measurement process shall require a quantification of risks under a range of outcomes using risk measurement techniques that are appropriate to the nature, scale and complexity of the risks. Section 2 shall include detailed descriptions and explanations of the risks identified, the measurement approaches used, key assumptions made and outcomes of any plausible adverse scenarios that are run. Examples of relevant material risk categories may include, but not be limited to, credit, market, liquidity, cash flow mismatch, underwriting, claim, expense, operational and risks associated with group membership.
23. Attached are three examples that illustrate how the outcomes of risk measurement could be presented for risk categories identified within a life insurance company (attachment 1), a property casualty company (attachment 2) and a health insurance company (attachment 3). For each risk category identified, the minimum quantitative elements that should be reported are the notional amount of risk which identifies the total exposure the company has to that particular risk, the expected value of that risk under normal conditions which identifies the amount of expected payment under normal conditions due to that risk over the next year and the expected value of that risk under stressed conditions which identifies the amount of expected payment under stressed conditions due to that risk over the next year. The company shall also report for each risk category a reverse stress test which would identify, given the company's current economic



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capital, the level of the stress factor which would have to unfold to cause the insurer to fail. Reverse stress testing can be helpful in identifying the risks that are most likely to cause an insurer to fail.

24. Because the risk profile of each company is unique, U.S. insurance regulators do not believe there is a standard set of stress conditions that each company should run, however the regulator may have input regarding the level of stress that company management should consider for each risk category. Unless a particular assumption is stochastically modeled, the company management will be setting their assumptions regarding the expected values based on their current anticipated experience studies and what they expect to unfold over the next year. The regulator may provide input to company management on a stress factor that should be applied for a particular assumption that is not stochastically modeled. For assumptions that are stochastically modeled, the regulator may provide input on the level of the measurement metric to use in the stressed condition or specify particular parameters used in the economic scenario generator.
25. By identifying each material risk category independently and reporting notional amounts, expected amounts in both normal and stressed conditions, company management and the regulator are in a much better position to evaluate certain risk combinations that could cause a company to fail. One of the most difficult exercises in modeling company results is determining the relationships, if any, between risk categories. History may provide some empirical evidence of relationships, but the future is not always best estimated by historical data.

Section 3 – Prospective Solvency Assessment

26. Section 3 of the ORSA shall document 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 business over the longer term business cycle such as the next 3-5 years. Most companies, as part of their strategic planning process, compile a 3-5 year business plan. Section 3 of the ORSA shall contain a demonstration that; given the current capital requirements both economic and regulatory, the quality of that capital, the current risk management policy consisting of its current risk tolerance limits, current risk exposure amounts in both a normal and stressed environments and the projected 3-5 year business plan; the company has the financial resources necessary to execute its 3-5 year business plan. If the company does not have the necessary financial capital or quality of capital to execute the 3-5 year business plan, the company shall describe the management actions it will take or describe any modifications to the business plan it has made to resolve the adequacy of its financial capital.
27. The prospective solvency assessment is in effect a feedback loop. The company shall project its future financial position including its projected economic and regulatory capital to assess its ability to meet the regulatory capital requirements given its current risk profile, its current risk management policy, its current quality and level of capital and reflecting any changes to its current risk profile caused by executing the 3-5 year business plan. The prospective solvency assessment shall also consider both normal and stressed environments.
28. Since the prospective solvency assessment will be done for each individual insurance company legal entity, the assessment shall take into account any risks associated with group membership. Such an assessment may involve a review of any group solvency assessment and consider any constraints on group capital or the movement of group capital to legal entities.

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