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John R. Kasich, Governor

Mary Taylor, Lt. Governor/Director

Introduction to ERM & ORSA

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Jeffery A. Becker, Examiner In-Charge
Office of Risk Assessment
Ohio Department of Insurance
Jeff.Becker@insurance.ohio.gov

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Background

- International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP) 16 - Enterprise Risk Management (including ORSA) and ICP 8 – Risk Management & Internal Controls.
  - ICPs are used by the International Monetary Fund (IMF) to perform the Financial Sector Assessment Program.
- Financial Sector & Assessment Program (FSAP).
- Improve Solvency Regulation in the U.S.
- Assist the regulator with Risk-Focused Analysis and Examinations.
- Aid the ability to evaluate the insurer’s ability to withstand stresses.

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What is ERM?

- Enterprise Risk Management ("ERM") - the process of planning, organizing, leading, and controlling all activities of a company in an integrated fashion in order to minimize the effects of risk on the company's capital and earnings.

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Why ERM for Insurers?

Regulatory Drivers

- Solvency II, European
- SOX
- Dodd-Frank
- Regulators/Audits
- Banking and Securities
- *NAIC “ORSA” …..*

Business Drivers

- Strategic Analysis
- Rating Agencies (S&P, AM Best, Moody’s)
- Financial Auditors
- Shareholders and other stakeholders

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Benefits of ERM

BEFORE ERM

- “Siloed” approach
- Weak risk assessment process
- Qualitative measurements
- Reactive focus on mitigation
- Risks ID’d but not *Owned*
- Risks perceived only as threats

AFTER ERM

- Collaborative approach
- Strong risk assessment process
- Quantitative measurements
- Proactive focus, “best practices” controls
- Risks Owned, monitored and tested
- Better alignment of all business units towards strategic company goals

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A New Perspective

Adopting an ERM program is often a major cultural change for many companies.

Implementing ERM

- Who Is/Should Be Involved?

- Strategic Decision-making, Financial Modeling & Capital Analysis

Setting Effective Controls

A primary goal of ERM is to ensure, company-wide, that controls are effective and are operating as intended to **mitigate risk/loss.**

Customized suites of specific control techniques, policies, and procedures are used to reduce or mitigate identified risks.

Controls won't eliminate 100% of all risk.
BUT, well-developed, sustainable controls can have a direct financial impact on the company.

Significance of ERM/ORSA

ICP 16 states:

- A purpose of both risk and capital management is to protect policyholders and capital providers from adverse events.
- ERM is an acknowledged practice and has become an established discipline.
- The ability of an insurer to reflect risks in a robust manner in its own assessment of risk and solvency is supported by an effective overall ERM framework, and by embedding its risk management policy in its operations.

Significance of ERM/ORSA

- Focuses on enterprise risk management practices as well as outcomes.
- ORSA considers the insurers “Own” assessment.
- Sophistication of an insurer’s ERM and the nature of the ORSA depends on the nature, scale and complexity of its risks, business and structure.
- Benefits to Insurers.
  - Improves ability to identify and mitigate risks.

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Regulatory Requirements

- *Risk Management and Own Risk and Solvency Assessment Model Act.*
  - Legal framework for ORSA requirement.
  - Adopted by NAIC Executive/Plenary on Sept. 12, 2012.
- *NAIC ORSA Guidance Manual.*
  - Provides guidance to insurers/groups for reporting on ORSA.
  - Adopted by NAIC in March 2012.
  - Revisions currently under consideration by the Working Group.

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NAIC Own Risk and Solvency Assessment Guidance Manual

- The Manual is intended to provide guidance to an insurer and/or the insurance group with regard to reporting on its own risk and solvency assessment (ORSA).
- ORSA Summary Report should discuss three major areas:
  - Section 1 – Description of the Insurer's Risk Management Framework.
  - Section 2 – Insurer's Assessment of Risk Exposure.
  - Section 3 – Risk Capital and Prospective Solvency Assessment.

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NAIC Own Risk and Solvency Assessment Guidance Manual

SECTION 1 – DESCRIPTION OF THE RISK MANAGEMENT FRAMEWORK.

- An effective Enterprise Risk Management (ERM) Framework should at a minimum include the following key principles:
  - Risk Culture and Governance.
  - Risk Identification and Prioritization.
  - Risk Appetite, Tolerances and Limits.
  - Risk Management and Controls.
  - Risk Reporting and Communication.

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SECTION 2 – INSURER ASSESSMENT OF RISK EXPOSURES.

- Document the quantitative and/or qualitative assessments of risk exposure in both normal and stressed environments for material risk categories.
- This assessment should consider a range of outcomes using risk assessment techniques that are appropriate to the nature, scale and complexity of the risks.
- Examples of relevant material risk categories might include, but not be limited to, credit, market, liquidity, underwriting, and operational risks.

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SECTION 3 –RISK CAPITAL AND PROSPECTIVE SOLVENCY ASSESSMENT.

- 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 current business and over a longer term business cycle.
- If the insurer does not have the necessary available capital to meet its current and projected risk capital requirements then it should describe the management actions it has taken or will take to remediate any capital adequacy concerns.
- The information is intended to assist regulators in forming subjective assessments of the quality of insurer's risk and capital management.

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Risk Management and Own Risk and Solvency Assessment Model Act

Act imposes three core requirements on a state's domestic insurers (unless exempt):

- Maintain a risk management framework.
- Complete an Own Risk and Solvency Assessment (ORSA).
- File an ORSA Summary Report with the insurance commissioner.

Risk Management and Own Risk and Solvency Assessment Model Act

- <u>Act includes Provisions for:</u>
  - Exemptions.
    - <$500 million Premium for insurers.
    - <$1 billion Premium for groups.
  - ORSA documents are Confidential.
  - Act will be effective on January 1, 2015.
    - The first filing of the ORSA Summary Report shall be in 2015 and no deadline date has been imposed.

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ORSA

- Current Status – ORSA (E) Subgroup.
  - 2012-2013 ORSA Feedback Pilot Project.
    - Conducted in July 2012 – 14 volunteer insurers/groups.
    - Provided Feedback to Industry.
      - http://www.naic.org/committees_e_orsa_wg.htm
    - ORSA Subgroup Report to Financial Condition (E) Committee.
      - Make a few modifications to the ORSA Guidance Manual.
      - Post observations to NAIC website.
      - Referrals sent to Financial Analysis and Financial Examination Handbook Working Groups - Subgroup to continue to provide guidance to these Groups.
      - No Part B Accreditation Standards at this time.
      - 2013 ORSA Pilot .

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ORSA

- Next Steps for Regulators.
  - 2014 ORSA Feedback Pilot Program.
- Comments from members of the Risk Focused Surveillance Working Group were due on March 7, 2014.
- Identify the Roles of Financial Analysts and Financial Examiners in the review of ORSA and Draft Regulatory Guidance.
- Then exposed publicly and later adopted into the analyst and examiner handbook.

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How does ERM / ORSA affect product and pricing?

- Management must understand the risk appetite of the product being sold.
- Management must also determine limits.
  - Where do I want to sell this product?
  - How much of this product do I want to sell?
  - What are the regulatory constraints regarding this product?
  - Other risks related to product and pricing.

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What does ERM / ORSA have to do with modeling?

- An adequate ERM / ORSA program has implemented a modeling governance framework.
  - Data validation is conducted.
  - Models are back tested as a result of strategic decisions made by management.
  - Identify what items or circumstances weren’t taken into account.
  - Includes three lines of defense
    - Risk takers
    - ERM
    - Internal Audit

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How has ERM / ORSA changed risk identification?

- Lets talk about risks that exist today and those that didn't exist 20 years ago.
  - Terrorist risk
    - No 9/11
  - U.S. cities default
    - Detroit
    - Several state economies stressed
  - Oil spills
  - Bed bugs: Includes business interruption.

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How has ERM / ORSA changed risk identification? Continued

- Power grid outage of August 14, 2003.
- Audio / visual of vehicles getting to close.
- Asian carp are presently in the Mississippi river and the fear is that they'll reach the Great Lakes and impact a $7 billion fishing and tourism industry.
- Default on sovereign debt: Portugal, Italy, Ireland, Greece and Spain.

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Potential emerging pricing risk

- Flood Insurance
  - Belief is that the federal government looks for the private insurance industry to begin writing flood insurance on company paper.
  - Management needs to ask how much should we insure?
  - Maintain pricing discipline.
  - Result of Briggert-Waters Act, aka, Flood Insurance Reform Act of 2012.

- Questions?

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