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US RMORSA: Preparing for the challenge

Overview

The Risk Management and Own Risk Assessment (RMORSA) Model Act is a new US insurance regulation, which is expected to be effective by 2015 and will lead to a shift in how insurers manage risk and conduct business. Regulators, rating agencies, investors and senior management are demanding risk and capital analytics to both provide information and make strategic business decisions.

Components of the RMORSA Model Act

The RMORSA Model Act is the model law that will be enacted at each state which will require US insurers to perform an Own Risk and Solvency Assessment (ORSA) and submit an *ORSA Summary Report* to their regulator each year. The RMORSA Model Act states that the ORSA Summary Report must conform to the requirements that are detailed within the *ORSA Guidance Manual*.

The *ORSA Guidance Manual* is an independent document maintained by the National Association of Insurance Commissioners (NAIC) and is intended to provide guidance to insurers on how to report the findings from their Own Risk and Solvency Assessment. The Own Risk and Solvency Assessment is specified within the *ORSA Guidance Manual* as "an internal assessment of the risks associated with an insurer's current business plan, and the sufficiency of capital resources to support these risks." The RMORSA Model Act is expected to be effective 1 January 2015, with insurers submitting their first *ORSA Summary Report* during 2015.

Key objectives of the RMORSA regulation

The intent of the RMORSA Model Act is to place more ownership on insurers regarding their solvency assessment. This increased ownership will be fostered from the requirements to regularly complete an ORSA and annually submit an ORSA Summary Report to the regulator. In addition, Section 3 of the RMORSA Model Act requires insurers to maintain an effective risk management framework in order to assist the insurer with identifying, assessing, managing and reporting on its material and relevant risks.

Three key sections of the ORSA Guidance Manual

The three sections of the ORSA Guidance Manual describe the topics that should be addressed within the ORSA Summary Report. They are as follows:

- *Section 1* is labeled the "Description of the Insurer's Risk Management Framework" and covers topics such as risk governance, risk identification, risk tolerances, risk management controls and risk reporting.
- *Section 2* is called the "Insurer Assessment of Risk Exposures" and describes both the quantitative and qualitative assessments of risk exposure, using a range of scenarios and the associated documentation of the key assumptions used.
- *Section 3* is collectively called the "Group Economic Capital and Prospective Solvency Assessment" but is broken into two parts. The first part covers the group capital assessment and other enterprise considerations, such as capital fungibility and diversification benefits, while the second part covers capital forecasting capabilities and business planning.

The broader implications of RMORSA

The RMORSA Model Act is the first step toward viewing solvency capital from an economic perspective. Although the regulation is not as comprehensive as other global solvency initiatives, such as Solvency II, it will compel US insurers to adopt global best practices. The risk management framework sections within the RMORSA Model Act and ORSA Guidance

Manual will require insurers to develop a risk management function that is empowered by policies set by an insurer's management board. The Own Risk and Solvency Assessment can be a centralized source of information for regulators, rating agencies, asset-liability management and risk management.

Key findings from the IBM benchmarking study

The IBM benchmarking study on the state of readiness of US insurers to address the requirements of RMORSA yielded the following key findings.

Section I

The first set of survey questions deals with the required components of the insurer's risk management framework, which are detailed in Section 1 of the ORSA Guidance Manual. These questions are centered around risk governance and culture, risk identification and risk prioritization. Although insurers have made progress in defining approaches for these requirements, further development is needed, because while 77 percent of firms have fully defined approaches, only one-third of firms have fully implemented these measures.

A critical aspect of effective enterprise risk management (ERM) is the ability to understand the firm's risk profile in both normal and "stressed" market conditions. The survey responses indicated that only one-sixth of firms have fully embedded systems and assessment tools that allow them to monitor and respond to changes in their risk profile.

An essential part of an effective risk management framework is the articulation by senior management of the type and acceptable magnitude of risks that a firm is willing to take. The survey showed that the creation of a risk appetite statement is a key area of development for insurers, with nearly one-half of firms not having defined an approach to address this.

Section II

A crucial first step in the quantification of risk capital is the development of scenarios that consider an appropriate range of outcomes, given the complexity of the product. The survey results for this topic showed that although 60 percent of companies have developed an appropriate approach to quantify risk capital, only 20 percent have fully implemented their approach.

Section 2 of the ORSA Guidance Manual addresses both risk tolerance limits and model validation. Risk tolerance limits aid insurers by setting risk boundaries that are aligned with the vision of senior management, whereas model validation provides the credibility and assurance that the capital figures are reliable. The survey results for these components showed that slightly more than half of companies have not fully developed approaches to address either model validation or risk tolerance limits. This result was also confirmed by the NAIC in its initial feedback on the ORSA pilot program, where they stressed the need for detail around risk tolerance limits within the ORSA Summary Report.

Section III

Capital aggregation at the insurance holding company can be quite complex, given the various financial structures that can exist at individual legal entities. Because of this complexity, it is vital to develop a dynamic framework for aggregating holding-company capital under both normal and stressed environments. The survey results showed that while 35 percent of insurers have fully implemented these measures, nearly 40 percent have yet to develop an approach.

One of the important ORSA requirements is the ability to project capital over the business-planning horizon, under both normal and stressed environments. Having this capability will enable insurers to analyze and potentially adjust the business plan in order to ensure adequate capital levels. The survey results for this topic were fairly evenly distributed across the potential responses, with 38 percent of insurers still needing to develop an approach.

Conforming to RMORSA requires that insurers operate differently

For insurers that do not have a robust risk management function, the effort to conform to the RMORSA Model Act may be significant. The RMORSA Model Act requires that insurers maintain a risk management framework, but it is the ORSA Guidance Manual that details the requirements that make an insurer's framework effective. An insurer that is found to be deficient in meeting these requirements could experience increased supervision by the regulator.

In addition to the development of an ERM framework, insurers will need to specify how they intend to calculate risk capital. The regulation specifies that "[insurers] should have sound processes for assessing capital adequacy in relation to their risk profile and this process should be integrated into its management and decision making culture." This directive will require insurers to develop a framework and associated methodology for determining the level of capital needed to manage its business. This is a significant work effort and could be compared to the development of an internal model within Solvency II.

This internal framework is also intended to be used as a decision-making platform throughout the organization. This is similar to the Use Test within Solvency II and could lead to changes in how products are priced and managed.

Fully implementing the RMORSA Model Act: Challenges for insurers

One of the biggest challenges facing insurance firms will be the organization structure. Many departments will be stakeholders in the ORSA, including actuarial, risk, finance and IT. Insurers will need to determine which group owns the ORSA methodology, processes and report submission. This "ORSA group" must coordinate with the other stakeholders to ensure that all of the necessary inputs can be brought together to produce the ORSA Summary Report. This may require modifications to the organizational structure or the creation of new procedures.

From a qualitative perspective, insurers need to evaluate their ability to address the risk documentation and the risk appetite statement requirements within the ORSA Guidance Manual. Also, insurers will need to either create or enhance their risk methodology function in order to address things like capital determination, risk assessment techniques, key assumptions and adverse scenarios. In addition, the alignment of the risk appetite statement and tolerances with senior management objectives will be a critical step in the ORSA process.

From a quantitative perspective, insurers will need to evaluate their risk management platform and determine whether it's suitable to perform the ORSA capital calculations. Does it have the capability to revalue assets and liabilities across thousands of risk-neutral or real-world scenarios? Does their platform use proxy methods, such as replicating portfolios or curve fitting to assess capital exposure under a wide range of outcomes? Also, insurers must consider whether their current platform is flexible enough to provide an ad hoc request from senior management.

There are additional challenges that insurers will face, such as data management and consolidation, capital fungibility modeling, capital forecasting and the level of granularity presented in the summary report.

Repercussions of viewing RMORSA as simply a compliance exercise

One of the purposes of the RMORSA Model Act is to require insurers to develop the tools necessary to analyze their risk exposure and to incorporate those tools into their business decisions. Firms that view RMORSA as merely a compliance exercise may be underprepared for certain risk events, such as hyperinflation or a mortality pandemic. Also, if the risk management framework is not driving business decisions, a company could develop products that are improperly priced, which could lead to capital losses.

Companies that do not develop the necessary tools to properly support the risk-management framework could be exposed to increased regulatory scrutiny and supervision. Also, an inferior ORSA Summary Report could even lead to a potential ratings downgrade if rating agencies use the information.

Tooling up to meet the objectives of RMORSA

Insurers will need to develop a comprehensive stochastic-modeling platform for liabilities. Insurers will also need to incorporate tools that allow them to project both assets and liabilities under real-world scenarios. Insurers will need a solution that aggregates balance-sheet financials and reports capital impacts under a variety of scenarios. In addition, they will need tools that enable them to quickly revalue the balance sheet after market shocks. Lastly, firms will need tools to assist with the internal audit and tracking requirements of RMORSA.

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