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AMERICAN ACADEMY *of* ACTUARIES

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May 16, 2014

Mr. Jim Hattaway, Co-Chair  
Mr. Doug Slape, Co-Chair  
Risk-Focused Surveillance (E) Working Group  
National Association of Insurance Commissioners  
Via email: c/o Becky Meyer ([bmeyer@naic.org](mailto:bmeyer@naic.org))

Re: Comments on ORSA Guidance in the Financial Analysis and Financial Condition Examiners Handbooks

Dear Mr. Hattaway and Mr. Slape,

On behalf of the American Academy of Actuaries<sup>1</sup> ORSA Subgroup, I appreciate the opportunity to provide comments on the April 2014 drafts of guidance on Own Risk Solvency Assessment (ORSA) review to be incorporated in the *Financial Analysis Handbook* and the *Financial Condition Examiners Handbook*.

### **General Comments**

We applaud the effort to develop detailed guidance for analysts and examiners related to review of ORSA reporting. An ORSA is the latest developmental tool that has been implemented to support the transition to risk-focused examinations. Since the financial crisis, we recognize there has been an expectation that regulators include macro assessments of the industry and affiliated entities along with a traditional micro focus on specific firms. As such, the examination process needs to more clearly identify the kinds of conversations that should be occurring between a company and its regulator, as well as among regulators. One element that could be better addressed in the guidance is the kind of information and action that the regulator is expected to engage in during and following the examination related to macro risks. This needs to be more directly acknowledged in the handbooks, beyond the reference that an ORSA will help prioritize the risk -focused exams. For example, it could be noted that an ORSA may allow the regulators to better understand, analyze, discuss, and regulate industry risks that are not well addressed in the current regulatory processes.

In light of the developing practices in enterprise risk management (ERM) and ORSA reporting, the early stages of ORSA use by the regulatory community, and the desire by the NAIC to maintain a principles-based approach, additional time may be needed to fully develop an approach for using an ORSA report as part of financial surveillance. We therefore suggest

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<sup>1</sup> The American Academy of Actuaries is an 18,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

guidance to examiners and analysts in the first few years of ORSA reporting that is more focused on developing a general understanding of ORSA and ERM, with a transition over time into more direct use and review of ORSA as part of the examination process. We understand that training for examiners and analysts on ORSA and ERM is planned, and, to the extent the Academy can support these efforts, we would be pleased to discuss this further with you.

The users of the document may benefit from more specific guidance on how the results of ORSA may be used as part of the analysis and exam process. There is helpful educational material in the document, but it may be useful to include more specific guidance on how ORSA information will affect the exam procedures and which risks will be considered in the risk-focused examination. For example, ORSA reporting may help regulators understand current insurance market risks, changes in those risks, macro issues that are significant, etc., and that may guide the evaluation of the insurer risk profile. There should be a clear link between an ORSA and the assessment of inherent and residual risks in a risk-focused exam.

We agree with the general approach to encourage analysts and examiners to allow for a range of ERM approaches and ORSA reporting. Examples of cases in which this approach is clearly highlighted include statements in the *Financial Analysis Handbook* such as: “the analyst should NOT use the following guidance in a way that dictates specifics on the report,” and “to emphasize U.S. insurance regulators are strongly supportive of an ORSA process and ORSA Summary Report that emphasizes the ‘Own’ and any discussion by the analyst with the insurer should recognize this important concept.”

We also agree with the view that specific ERM processes may not be applied at the legal entity level, depending on the facts and circumstances for each company. ERM analysis for the group, even if not done for each legal entity, can still be robust.

We agree with the general approach that, depending on the robustness of a company’s ERM program, the scope of regulatory procedures will be affected. It would be efficient to adjust the extent of regulatory review procedures up or down depending on how well the company identifies, measures, and manages its risk exposures. This concept should be introduced more clearly at the start of each handbook. This would help the user understand that the ultimate goal of using an ORSA report is to facilitate a better risk assessment for purposes of a risk-focused exam, as opposed to being subject to an exhaustive independent examination process. It also would be helpful to clarify when in the exam process an ORSA report would be analyzed (e.g., it may be considered early in the examination, as part of planning, in order to facilitate development of appropriate risk-focused examination procedures).

We appreciate recognition of the role of the regulatory actuary in review of ORSA. In particular, the *Financial Analysis Handbook* states: “Although the analyst is expected to make this initial determination, most states believe there is value in including the examiner-in-charge and actuary in the initial discussions with the insurer since the same team will be a part of the ongoing monitoring of the insurer and an ORSA Summary Report is expected to be at the center of the regulatory processes.” There are many components of an ORSA report that involve actuarial analysis and, therefore, actuarial involvement in the review of ORSA will be helpful as part of the analysis and examination process.

While use of the RIMS maturity model as a basis for assessment appears to provide useful educational material for the analyst and examiner, this maturity model is not specific to insurance and, therefore, it is important that the characteristics of each maturity level be viewed only as a rough guideline (i.e., the judgment of the regulator is needed to interpret where on the spectrum each company sits compared with a strict application of the maturity definitions in the document). Specific comments on the maturity model and its application to insurance can be found below. The Academy's ERM Committee has published a document on ERM practices that may provide useful background material.<sup>2</sup>

In addition, the Actuarial Standards Board (ASB) recently developed standards of practice for actuaries performing ERM work.<sup>3</sup> Finally, the Academy's ORSA Subgroup is writing a document on how ORSA can support the regulatory review process, which we will share with interested regulators upon completion. These documents provide information regarding ERM practices that are specific to the insurance industry and reflect emerging best practices.

We agree with idea of proportionality as outlined in the documents—in other words, a smaller and/or less complex insurer may have a lower ERM maturity.

With respect to capital assessment, there are several references to inclusion of “qualitative” elements in the capital assessment. The guidance should more clearly differentiate when the assessment should rely on qualitative versus quantitative elements. While reliance on particular capital models (e.g., rating agency, regulatory, internal, etc.) can be based on qualitative assessments of the applicability of each approach, the models themselves should be based on primarily quantitative assessments.

In addition, the draft handbooks appear to suggest that each legal entity or regional supervisory examiner may be doing an assessment of the insurer's internal model. Since a company's internal model typically is used for a group capital assessment and tends to be a very complex analysis, we recommend the group supervisor take the lead on such a review, rather than having this undertaken by multiple regulators as part of standard procedures. We suggest providing guidance on the circumstances in which an examiner may need to review the internal model and what procedures may be appropriate based on those circumstances.

We also suggest making it clear that internal model validation is not necessarily part of ORSA standard procedures for an examination.<sup>4</sup> In an ORSA context, it may be more appropriate for the group-wide supervisor to seek to understand the processes by which the company assesses the accuracy and robustness of its model(s), and by which it governs model changes and parameter or assumption setting. Model validation by the examination team should be driven by

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<sup>2</sup> [http://actuary.org/files/ERM\\_%20Practice\\_Note\\_July\\_2013\\_0.pdf](http://actuary.org/files/ERM_%20Practice_Note_July_2013_0.pdf).

<sup>3</sup> ASOP No. 46: [http://www.actuarialstandardsboard.org/pdf/asops/asop046\\_165.pdf](http://www.actuarialstandardsboard.org/pdf/asops/asop046_165.pdf) and ASOP No. 47: [http://www.actuarialstandardsboard.org/pdf/asops/asop047\\_169.pdf](http://www.actuarialstandardsboard.org/pdf/asops/asop047_169.pdf).

<sup>4</sup> An ORSA situation differs from the case in which an internal model is used to calculate required capital within a formal solvency regime, such as for Solvency II or the Swiss Solvency Test. In such instances, there are requirements for model validation and supervisory signoff.

concerns tied directly to the purpose of the risk-focused exam.

Some additional education and guidance for the financial examiners and analysts regarding risk interactions and diversification would be helpful. This is a fundamental issue for insurers. For example, a key consideration within any ERM program is the effect of correlation and diversification among products, business units, and risks. We suggest adding some commentary regarding these two topics in the introductory remarks and also in specific guidance areas. In addition, risk identification and quantification may consider risk diversification.

### **Specific Comments on *Financial Analysis Handbook***

*(The line numbers below refer to the line on the page if “continuous line numbers” is selected under page layout)*

Page 5-6, in the list of specific risks—We agree that the definition of the nine risks listed may differ from how the insurer defines and categorizes risks. It may be worth pointing out some of the expected significant differences, such as the following:

- For most insurers, credit risk is defined to include balance sheet impacts due to movements in market spreads and migration of assets across rating classes, not just default risk.
- For most insurers, market risk considers impacts on both sides of the balance sheet (i.e., assets and liabilities), not just the impact on “market value of investments.”
- Many insurers consider pricing, underwriting, and reserving to be processes, and the underlying risks are related to weather patterns, future inflation, coverage interpretation, mortality, morbidity, policyholder behavior, expense, etc.

Page 8—While typically a component of risk culture, one consideration not mentioned in this section is the extent to which formal risk training exists in the organization. In addition, there are some statements within the risk maturity sections that may not be clear to the user, particularly if the user is not an ERM expert, including:

- “Risk culture is associated with career development” in line 332.
- “One area has used the ERM Process” in line 351 (perhaps this should be “One or more business units or functional areas...”).
- “Controls are based on departments and finances” in line 369.

These comments also apply to Page 5 of the *Financial Condition Examiners Handbook*.

Page 9—Typically, risk identification processes involve a consistent, defined-risk taxonomy as a starting point to facilitate consistent risk definition and categorization. We suggest mentioning this in the maturity definitions, at least for “leading” and “managed” practices. We suggest adding some reference to the risk assessment process and the use of impact, likelihood, and speed of onset scales in the *Leadership Practices* section of the handbook. In addition, the statement on line 377 that states “Internal and external best practices, support functions, business lines, and regions are systematically gathered and maintained” is confusing because it is not clear how some of these items could be gathered or maintained. These comments also apply to Page 6 of the *Financial Condition Examiners Handbook*.

Page 10—The meaning of the statement “The organization manages business areas and has a diverse portfolio collection to balance risk positions” in line 454 is not clear. This comment also applies to Page 8 of the *Financial Condition Examiners Handbook*.

Page 11—We suggest that both managed practices and repeatable practices include reference to having a defined risk appetite statement, as this is a basic tenet that is present in a good (not necessarily “leading”) ERM program. This comment also applies to Page 8 of the *Financial Condition Examiners Handbook*.

Page 12—It is not clear what is meant by the statement “Management is clearly defined and enforced at every level” in line 521. Perhaps this should say “Risk management is clearly defined....” This comment also applies to Page 9 of the *Financial Condition Examiners Handbook*.

Page 14—We suggest adding a question that asks for examples of cases in which ERM processes have resulted in different strategic decisions at the company. This typically provides evidence that risk culture is strong and risk-management processes are actively used.

Page 18—We agree with the comments in the second paragraph.

Page 21—Line 916 references “more extreme situations” that insurers may use for stress testing as compared to economic capital. Economic capital stresses typically are extreme-tail (for example 1/1000) events, and stress testing should contemplate moderately adverse stresses. We would suggest recognizing this by changing the language to refer to “more or less extreme situations.” It is important to recognize that risk management terminology for things such as the classification of risks will differ among insurers and from regulatory definitions.

Page 21—We agree with the comments in the second paragraph. We also have the following specific comments on the list of example stresses on Pages 21-22:

- Within credit, we suggest a further distinction between default risk and risk of movement in spreads. We suggest moving the equity security loss item from credit to market.
- We suggest a reference to morbidity in pricing/underwriting because this risk is critical for health insurers in particular.

These comments also apply to Page 15 of the *Financial Condition Examiners Handbook*.

Page 22—We suggest striking the paragraph at the bottom of the page, starting on line 1001 for the following reasons:

- Leading practices already are covered in the document in a more general way.
- The list is incomplete in terms of describing best practices for assessment of risk exposure.
- Actual best practices will vary depending on the facts and circumstances of each insurer, and, therefore, some of the items listed may be missing for a specific insurer that is following best practices. Consistent with the overall tone of the document, we suggest a more principles-based approach to reviewing an ORSA, with no specific “checklist” expectations.

Page 24—The statement in line 1052, “insurer combines the qualitative elements of its risk management policy with the quantitative measures of risk exposure in determining the level of capital needed” is confusing. It is not clear how a qualitative element is quantified for purposes of capital.

Page 25—On line 1083, the definition of economic capital (i.e., a comparison of the required capital per the calculation of various types of material risks to the amount of capital available to pay claims) is confusing. It may be clearer to define required economic capital as the amount needed to cover risk exposures over a defined time period and with defined confidence, and then separately define available economic capital as the amount available based on an economic balance sheet. We disagree that calculations for available capital “are generally based on a market consistent (fair value) balance sheet, wherein GAAP equity may be used as a starting point...” (line 1085). U.S. companies generally have moved away from a “pure” market consistent or fair-value approach. Instead, they use an internally defined version of economic value, which allows for consideration of the long term, illiquid, and non-traded nature of many insurance liabilities. In addition, valuation of insurance liabilities for an internal economic balance sheet is commonly done directly rather than by starting with their U.S. GAAP statement value. We also suggest that the document make reference to another, relatively common, method of defining the economic balance sheet, which involves a projection of the statutory balance sheet over a long period of time, typically called the “statutory runoff” approach.

Page 25—We disagree that “most insurers that utilize economic capital models use them as much for day to day decisions as they do group capital management” on line 1102. While this is true for companies in the “leading” maturity bucket, it can take quite a bit of time to evolve to this level of use. A company can have good ERM practices but not yet use economic capital models in day-to-day decisions. The sentence on line 1106 “in addition, because economic capital models are commonly the basis for which such groups manage their capital levels to the action or inaction by companies in response to material changes or immaterial changes can be revealing with respect to how much models are informative to manage in their day to day decisions” is confusing. Finally, we suggest that in the last paragraph, starting on line 1114, additional language be added on the challenges of backtesting economic capital models in light of their focus on tail events. While backtesting of models generally can be useful as a validation tool, it is almost impossible to backtest the required economic capital results, since an extreme tail event that is close in nature to that estimated in the model is rare. Perhaps referencing backtesting of specific risk distributions, or the baseline economic balance sheet, would be more informative.

Page 26—We disagree that “even insurers that use internal capital models will usually track their perceived capital requirements from such (rating agency) models and will include them in the ORSA summary report.” While we would expect to see statutory capital and, in most cases, some form of economic capital in an ORSA summary report, we would not necessarily expect companies to include rating agency capital, unless rating agency metrics are a component of their defined-risk appetite and tolerance. This comment also applies to Page 20 of the *Financial Condition Examiners Handbook*.

Page 28—In the discussion about capital “cushion,” it may be useful to distinguish between available capital and required capital. The use of the term economic capital or regulatory capital without specifying “required” versus “available” may lead to confusion.

Page 30—We suggest including commentary regarding the use of stress scenarios in the prospective solvency assessment (beginning on line 1329). It appears critical that prospective solvency, at least on a regulatory basis, be considered not only in a best-estimate scenario but also in stress scenarios. This comment also applies to Page 20 of the *Financial Condition Examiners Handbook*.

### **Specific Comments on *Financial Condition Examiners Handbook***

Page 11—An additional procedure that may be useful related to risk culture and governance is review of formal training materials on ERM.

Page 12—We suggest the addition of procedures for risk identification and prioritization:

- Reviewing the approach for and results of assessing risk likelihood, severity, and speed of onset.
- Verifying that top risks are assigned risk owners responsible for monitoring those risks and overseeing risk-mitigation plans.

Page 19—line 908 refers to “involving an actuary or individual with experience in advanced mathematics/statistics...” in reviewing the insurer’s internal model. We appreciate the reference to involving an actuary, since actuaries have both the advanced mathematics/statistics background needed along with a deep understanding of insurance company operations and risks. Use of only non-actuaries for this very complex and important task is unlikely to result in a robust review of the model.

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We appreciate the opportunity to provide you with these comments and would be happy to discuss these comments with you further. If you have any questions, please contact Heather Jerbi, the Academy’s assistant director of public policy, via email ([jerbi@actuary.org](mailto:jerbi@actuary.org)) or phone (202.223.8196).

Sincerely,

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