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The ORSA Requirement: Insurance Practitioners’ Concerns

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Abstract

ORSA requires every insurance company to demonstrate that it has an effective Risk Management program, with scenario analysis, stress testing and capital solvency models in place that can help it withstand normal and extreme risk events. Each ORSA report should have risk management activities unique to the company and provide a clear explanation as to the policies, processes, and procedures it uses to identify, treat, and monitor risks to the organization in a way that the report and models used reflect the most likely and accurate picture of the company's financial performance in normal and extreme situations. The bottom line for insurance undertakings in ORSA is to provide their regulators with an insight into their ability to manage risks and stay solvent.

This paper uncovers the concerns and respective dangers faced by Insurance undertakings when drawing up and using the ORSA report. It shows that, in practice there are some crucial concerns about this report, which need to be looked into and understood and which seemingly are not always being well addressed by the employees and the respective Boards. Thereby, the results of ORSA, may not be reliable and are prone to dangers and limitations. The aim is to trigger debate among insurance undertakings as to how they can apply and manage these concerns, dangers and limitations.

Solvency II, ORSA, Risk Management, Insurance Firms, Capital requirement

The ORSA Requirements: A Debate on the Concerns and Dangers.

Introduction

Insurance plays a significant role in the economy of a country by taking on the risks and mobilizing savings. If it functions well, it adequately contributes to financial stability and economic growth of the involved nation (Taylor, 2014 p. 34). With assets worth more than two-thirds of the European Union GDP, the European Union insurance is a significant part of the region's financial sector. Furthermore, insurance harbors more than a third of European liabilities, which entail household wealth that offers consumers an opportunity to depend on future income (Starita & Malafronte, 2014 p. 12). Thus, difficulties experienced by large insurance firms and their economies during the latest financial crisis have challenged regulators to rethink their methods of solvency assessment. Execution of Solvency II directive may be described as a consequence of this challenge regardless of the fact that it has been following the lamfalussy process since the year 2003. Lamfalussy process distinguished between the key values and principles and its guidelines to the sector's specific technical and compliance details. At the heart of this directive is the Own Risk and Solvency Assessment (ORSA) which is a set of processes constituting tools for decision making and strategic analysis (International Actuarial Association, 2015 p.7). The primary focus of ORSA is to ensure that insurance companies continuously assess their overall solvency needs in relation to their specific risk profile of the insurance company (Gründl & Gal, 2013 p. 45).

Framework Statement

This paper uncovers the concerns and respective dangers and limitations, faced by Insurance undertakings, when drawing up the ORSA report and of not reaping the full benefit from it. It

shows that, in practice there are some crucial concerns about this report, which need to be looked into and understood and which seemingly are not always being well addressed by the employees and the respective Boards. Thereby, the results of ORSA, may not be reliable and are prone to dangers and limitations. The aim is to trigger debate among insurance undertakings as to how they can apply and manage these concerns, dangers and limitations.

Key Objective of Solvency II

The key objective of Solvency II was to increase the levels of harmonization of solvency laws and regulations across the European region. The aim was to protect policyholders, offer appropriate motivation and incentives to ensure effective risk management and introduce Europe-wide capital guidelines that are sensitive to all types of risks being undertaken (Taylor, 2014 p. 33). During this time, the European Insurance and Occupational Pensions Authority (EIOPA) was responsible for the provision of support, and technical advice on the overall European Commission for a successful development of delegated acts towards the management of risk. It helped firms in understanding the most effective strategies that can be applied in control and management of the risks facing their demand lines, operations and administrative departments. Basically, Solvency II directive touches all European reinsurance and insurance companies experiencing a gross premium income of more than 5 million Euros (Starita & Malafronte, 2014 p. 25). Article 45 of this Directive highlights the requirements for Insurance and Reinsurance undertakings to conduct its ORSA as part of their risk-management system. As from January 1, 2015, each Insurance and Reinsurance (from here on captured under the word Insurance) undertaking is required to submit an annual risk management report to the regulatory authority of the state country.

Solvency II Framework Structure

The Solvency II framework is made up of three primary pillars. Pillar one looks at the minimum capital requirement that every firm must meet. Pillar two focuses on the systems of governance, risk management, and supervisory review process. In pillar two, every insurance firm is expected to carry out an ORSA. Finally, pillar three acts as the element that provides supervisory reports regime and helps in defining the requirements to the regulators (Gründl & Gal, 2013 p. 45). This study will focus mainly on pillar two.

Solvency II Framework Pillar Two

Pillar two sets out the core requirements for the roles, activities, and responsibilities of the key functions within the company. The board is tasked with the overall responsibility for ensuring compliance with the Solvency II requirements. Under pillar two, insurance undertakings are required to implement an actuarial function, risk management function, internal audit function and a compliance function. Furthermore, the requirement also mandates that the insurance firms have a clearly segregated structure of organization where responsibilities are distributed among its employees (Taylor, 2014 p. 56).

According to European Insurance and Occupational Pensions Authority, ORSA is entirely the procedures, strategies, and processes employed by firms to identify, monitor, assess, manage and report on the short and long-term risks their insurance firm may face. It helps in determining funds required to ensure that the entire solvency needs of insurance undertakings are met at all times (International Actuarial Association, 2015 p.1).

ORSA requires that any Insurance firm must identify all the risks to which it is exposed too and the related management plans, controls, and processes. It should cover all types of risks including strategic and reputational risk, which are not included in the standard formula provided

by this regulation and which the company is exposed too. Furthermore, ORSA requires that a company must quantify its capability to meet the Solvency Capital Requirement (SCR) and Minimum Capital Requirement (MCR) over its three to five-year business planning horizon (Feetham, 2011 p. 19). Basically, ORSA is one essential element that is evaluated by supervisors when making decisions about whether an additional capital “add-on” to the MCR is needed in the company (The Economic Capital). In that case, every insurance company is required to provide evidence to the supervisors indicating that senior management has used ORSA to calculate it’s risks in line with the various organizational activities such as strategic decision making (Taylor, 2014 p. 27). ORSA is built around a standard formula for the credit, operational, and market risks. Reputational, and strategic risks are calculated separately using internal methods. Furthermore, ORSA is used to determine the tolerance and appetite to risk of the firm (Re, 2012 p.12). Other than understanding the requirements and needs of ORSA and Solvency II, there are some crucial issues that the board and employees do not always consider and which may result in concerns, dangers and limitation in the ORSA report.

These concerns, dangers and limitations, were investigated through structured interviews (face-to face or using Skype), with 48 Insurance practitioners who are involved with drawing up the ORSA in Europe, who were asked about their concerns with the ORSA report they had prepared. Participants were recruited through personal contacts who also introduced other potential candidates, thereby avoiding the researcher’s bias in choosing the participants. The researcher was careful, while the interviews, not to express his thoughts and biases, which were kept to himself.

These concerns, dangers and limitations include:

Misunderstanding of Definitions and Terminologies

According to Taylor 2014, board members and employees who are responsible for the execution of ORSA, are not aware of the real meaning of risk. Naturally, the risk is perceived as an uncertain opportunity either positive or negative that influences the objective of a given group or firm (International Actuarial Association, 2015 p. 4). However, most board members and employees perceive it as personal danger. It affects the way they implement, craft and schedule controls to lower expected negative impacts on the results of ORSA (Miles, 2017 p. 45). Good communication and in-house training will play an important role in addressing this issue.

Also, the Regulators and Boards are most often happy with determining and understanding the value at risk up to a 99.99% accuracy using historic data, scenarios, and randomness. But, they do not understand that in statistician's terms this means the area under the normal distribution curve. Even when one calculates to 99.99% accuracy, the 0.01% tail can be larger than the 99.99% value at risk calculated. One can determine statistically the expected shortfall i.e. the size of this 0.01%, and carry out stress tests and back tests to verify the model in use and ascertain its usefulness in risk assessment (Dreher, 2015 p. 17). However, this is really and truly dependent on the assumptions made in determining risks and on how inclined the Board members are in understanding the risks at hand. In risk assessment, the board's knowledge and experience in management is very crucial in controlling risk. What is important is the identification of unexpected uncertainty with the insurance firm's performance structures and not as much the expected uncertainty (Dreher, 2015 p. 25).

Presenting an incomplete ORSA Document

Mile (2014) suggests that board members should understand all the risks associated with the ORSA itself in order to plan and create controls. He labels implementation of an incomplete ORSA as one of the main risks that affect the ORSA process (Miles, 2017 p. 49). Since, relying on such would mean having a false sense of security and responding inadequately to the solvency capital needs. To him, also overly complex assessments may overwhelm the board members and their employees, resulting in little or no success in the processes. Therefore, he suggests some strategies that are easily transferrable between one employee to another and which will ensure consistency in company scoring within the financial sector resulting in better performance of the ORSA criteria (Starita & Malafronte, 2014 p. 20). Efficient logical (IT) tools such as databases, used for example to maintain ‘the Risk Registers’ can help maintain information and ease communication and audit to enable knowledge and experience transfer among everyone in the firm.

Backward-Looking

In most cases, ORSA assessments are seen as being backward looking, therefore, leaving out some material risks faced by the insurance firms involved. That is, a firm may find itself looking at past events rather than performing in-depth analysis and predictions of future assessments (Starita & Malafronte, 2014 p. 33). As noted above, the regulators and Boards are most often happy with determining and understanding the value at risk up to a 99.99% accuracy using historic data. The identification of unexpected uncertainty is more important than that of only expected uncertainty in an insurance firm’s performance structure, since expected uncertainty would have already been addressed in the pricing structure of the Insurance undertaking. These gaps create a potential breakdown in achieving the correct results with ORSA.

Basically, a forward-looking and complete ORSA should have the capability to assess unexpected risk possibilities, which may be difficult to address in the main processes. Therefore, in order to achieve this, board members must restructure their insurance firm's communication channels to be top-down, bottom-up and horizontal (Taylor, 2014 p. 78). Workable communication channels ensure that each employee devotes maximum attention to the risk categories. Again IT can play an important part in ensuring that this is done efficiently.

Naturally, insurance firms may refine stress triggers and key risk indicators that expose the firm to risk. By doing this, they call for innovative scenario testing elements of the ORSA reports that work in reducing and controlling risk (Starita & Malafronte, 2014 p. 34). Generally, stress and scenario testing are very crucial in identifying and managing risks in the company, and therefore board members should consider it an important element when planning for risk management processes. For quality results, these tests should be drawn from the actual and perceived risks within the company. For instance, in stress tests, they should assess the impact of change that a single risk factor may have on their business (Stulz, 2008 p. 11). By doing this, the board members will be in a better position to follow the instructions of risk management in a way that will eliminate the dangers and limitations of achieving the correct ORSA.

Over-Reliance on ORSA

The risk of over-reliance on ORSA emerges where board members focus more on the process other than the results or the content. Most board members have a false sense of safety where they think that if the ORSA runs effectively, there is no possibility of risk to be undertaken (Feetham, 2011 p. 19). Therefore, the board must understand that ORSA is just an opportunity to effectively align regulatory reporting and management. Ideally, they should improve their

management information where they can actively monitor the material and service risks that they are exposed too (Starita & Malafronte, 2014 p. 42). Furthermore, they can implement a firm-specific relationship between the required capital and risks involved by restructuring governance controls and structures in order to improve the appropriateness of ORSA to the company. Therefore, the board members must use their capital levels as commensurate with the company's risk profiles in order to adopt risk management procedures that promote effectiveness in the firm. However, one must still be cautious when considering capital held as a passport for taking on risks, since this is highly dependent on the accuracy of understanding both the expected uncertainties and the unexpected uncertainties.

Under-reliance on the ORSA

As noted above, a requirement of the ORSA process is that every company must perform a comprehensive assessment to potential risks they are exposed to. Most board members make decisions that have no reference to the ORSA requirements and which are not related to the firm's risks (Feetham, 2011 p. 19). Following such case, capital calculations do not cover the material risks that the company is faced with and which bars the company's ability to detect other additional risks that the firm may face. Therefore, it is important that the board members adjust their Capital Requirement in order to consider capital add-ons on the overall process.

Moreover, the company's Supervisory Review Process (SRP) or risk manager may guide the board members in considering all possible adjustments that are needed to the regulatory capital. In that case, the board will be given suggestions and given an opportunity to debate on suggested capital add-ons (Economic Capital) that may be implemented in their structural requirements. The primary focus on applying this strategy is to motivate the board members to use the internal capital

model in determining their regulatory capital requirements in order to evaluate the individual risk situations in line with the company's strategy (Miles, 2017 p. 45).

Decision-Making Behavior

Decision making behavior and calibrating of the insurance firm's appetite and tolerance for risk determinants may have both positive and adverse effects on the requirements of Solvency II if not appropriately addressed. Personal emotions and biases within the board members structures may result in ineffective adoption and learning experiences which lead to incorrect approval of risk management decisions. Poor decisions making strategies result in the adoption of incorrect models hence failure in achieving realistic ORSA results. For instance, regret aversion may drive individuals to seek more confirming views while pressing hard on the inconsistent information. Therefore, group thinking in companies has a higher chance of resulting in incorrect or incomplete ORSA results, because decisions are based on general overlook rather than specific individual company needs (Starita & Malafronte, 2014 p. 43).

Also, a false sense of overconfidence and security originating from the firm's risk measurement techniques may result in reduced vigilance and attention to important information and data cycles. Therefore, employees and board members must evaluate each and every risk measure without relying on the positivity and potential showcased by risk management strategies (Sandströ, 2011 p. 29). Also, misalignment of perks and incentives within the company structure may boost the growth of biases within the company's organization. In this case, the board must ensure equality and equity among its employee structures and responsibility in order to promote good decision-making behavior.

According to Brooke (2010), understanding organizational finances provides a sense of risk understanding and how well systems work within the organization. Therefore, board members who do not understand or have no experience with the real behavior of money markets, may face challenges in creating decisions towards empowering the firms risk management technics. Brooke argues that many Board members fail to acknowledge experience of other insurance companies, thereby ending up in a condition whereby they cannot reinvent their risk management wheel. In simpler terms, he argues that lack of exposure within the board members may be dangerous to their execution of risk management strategies (Brooke, 2010). In that case, it is crucial for insurance managers and board members to rely on theories given by experienced insurers on how well to manage their risks.

Furthermore, inability to consider the social and interactive aspects of economic activities may also pose limitations and dangers. Inability to understand employee behavior may result in poor working conditions which affect performance. This is because they are linked to organizational behavioral capacity, which is very important in addressing the decision aggregates within the insurance company (Miles, 2017 p. 43). He suggests that board members must try to create stable relationships between the company and the social environment because a better understanding of behavioral finance plays a role in answering questions related to markets and money and which influences the achievement and implementation of ORSA requirements.

Organizational Culture and Structure

According to the report by the American Academy of Actuaries, a good knowledge of the organizational structure acts as an element that determines how well products and services move along the Insurance undertakings' demand line. Furthermore, it helps the insurance company in

understanding how inter-disciplines such as real estate markets, health and casualty works towards minimizing the risks involved in the overall organization product distribution (American Academy of Actuaries, 2016 p.7). Therefore, board members and employees must work with different teams in both insurance and non-insurance operations in order to collect appropriate information required to enable controlling and management of risk exposed to the company (American Academy of Actuaries, 2016 p.5). For instance, working with inter-discipline teams helps the firm in understanding how investment risks, regulatory risk, operational risks and catastrophe risks may expose the company to unprecedented uncertainties.

In this case, the board and its members must enhance their Enterprise Risk Management (ERM) processes, increase dialogue between regulators and the entity and improve their resilience towards risk management. Furthermore, the board may decide to use the ORSA requirements as guidelines in facilitating dialogues between the regulators and entities (American Academy of Actuaries, 2016 p.9). For instance, the enterprise or the firm may showcase their confidence and resilience in mitigating the risks involved (Starita & Malafronte, 2014 p. 38). On the other hand, the regulators may offer an independent perspective through which leads and questions regarding the risk are addressed. Basically, the main strategy here is to ensure that emotion attachment with the structure is withdrawn and every player in the risk control and management structure is working towards achieving an efficient and effective ORSA (American Academy of Actuaries, 2016 p. 10).

Additionally, the firm may create a management and board committee that is specifically directed towards understanding, evaluating, discussing and mitigating risks. By creating a special committee, the undertaking will be ensuring that both intrinsic and extrinsic risks associated with them are solved amicably and on time, since there will be a supported (buy-in) by all members.

Another option is creating different committees for different potential risks (American Academy of Actuaries, 2016 p.14). For example, the executive committee may create an ordinary executive risk committee that overlooks another committee such as the operational risk committee, the financial committee or the administrative committee. The primary concern within these committees is ensuring that the overall management performance and appropriateness of decisions meet the results of ORSA (Starita & Malafronte, 2014 p. 41).

Conclusion

It is clear that ORSA results are primarily affected by the Solvency II pillar two requirements. But, there are other sociological factors such as emotions, behavior, and communication within the structural organization of the company that have a greater impact on the overall success of meeting ORSA requirements. Therefore, the primary role of the risk management panel is assessing the risks available in the company, communicating them to risk-taking decision makers in the firm to manage, monitor and escalate the issues to the board members. If this communication is not smooth, it may expose the company to the dangers and limitation expressed above the expected results of ORSA. For proper implementation, control and management of risks, it is important for the board, its structure, and its employees to recognize ORSA as an excellent tool for regulators and undertakings (Starita & Malafronte, 2014 p. 31). It helps in obtaining a comprehensive understanding of the available insurer risks, methods of mitigating the risks, approaches of lowering the risks and a workable approach to dialogue regarding risk management.

Summary

The Own Risk and Solvency Assessment (ORSA) is a key element of the new European Solvency II regime. Article 45 of this Directive highlights the requirements for Insurance and Reinsurance undertakings to conduct its ORSA as part of their risk-management system. As from January 1, 2015, each Insurance and Reinsurance (from here on captured under the word Insurance) undertaking is required to submit an annual risk management report to the regulatory authority of the state country. It requires every insurance company to demonstrate that it has an effective unique Risk Management program (policies, processes, and procedures) to identify, treat, and monitor risks to the undertaking, with scenario analysis, stress testing and capital solvency models in place that can help it withstand normal and extreme risk events and to provide their regulators with an insight into their ability to manage risks and stay solvent.

This paper uncovers the concerns and respective dangers faced by Insurance undertakings when drawing up and using the ORSA report. In essence, the importance of ensuring a complete and accurate identification, measurement and understanding of risks faced by these insurance undertakings is highlighted. Also, highlighted is the importance of the ensuring that the ORSA report is linked to the firm's risks and that one must be careful when over-relying on ORSA results alone for decision taking. The tendency of the ORSA results to be an extrapolation of past experiences and therefore backward-looking was also noted. Moreover, the effect of sociological aspects such as organizational culture within the firm and the human elements such as personal emotions and biases within the board members structures was also considered.

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