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ERM Topics

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ERM Topics

1. The development and implementation of the ORSA
2. The contents of the ORSA filing
3. Initial feedback from the 2012 ORSA pilot
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The development and implementation of the ORSA

Developing an ORSA Guidance Manual for the US

“An insurer...will be expected to regularly conduct an ORSA to assess the adequacy of its risk management and current, and likely future, solvency position, internally document the process and results, and provide a high-level summary report annually to the domiciliary regulator, if requested”

NAIC Own Risk and Solvency Assessment (ORSA) Guidance Manual

- As part of the Solvency Modernization Initiative (SMI), the NAIC has adopted an ORSA requirement.
- The ORSA Guidance Manual was adopted in November 2011 after a period of intense industry comment and engagement.
- The NAIC has since approved a model law, that will implement the ORSA requirement with the first Summary Reports filed in 2015.
- A pilot exercise was run in 2012, and a further exercise in 2013 is possible.

The US ORSA is part of a global trend in insurance supervision

- The NAIC has adopted the ORSA requirement in response to the IAIS's ICP 16 – Enterprise Risk Management, which requires an ORSA.
- In common with other jurisdictions, the US is assessed against the ICPs under the Financial Sector Assessment Program (FSAP). The next review is expected in 2014.
- ORSA requirements are also being introduced in many other territories, include Europe, Bermuda and Canada.
- For international groups, the NAIC's intention is to recognize group ORSA's produced to meet another jurisdiction's requirements, where these are consistent with ICP 16 and the US guidance. The NAIC expects reciprocal recognition by overseas regulators of ORSA's prepared following US guidance.

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Regulators expect the ORSA to play a significant role in US insurance supervision

“The ORSA Summary Report may help determine the scope, depth and minimum timing of risk-focused analysis and examination procedures...Insurers with ERM frameworks deemed to be robust for their relative risk may not require the same scope or depth of review, or minimum timing for a risk-focused surveillance as those with less robust ERM functions.”

NAIC Own Risk and Solvency Assessment (ORSA) Guidance Manual

- **Risk management** – The ORSA will be a tool to help supervisors understand the risks insurers are exposed to, and how adept insurers are at managing those risks. Regulators plan to assess ERM capability, and to use it to guide their supervisory strategy
- **Group capital assessment** – Examiners and NAIC analysts will use the ORSA to assess groups' own assessment and management of their capital at group level. While the ORSA will not set a group capital requirement, it will provide information to regulators that will help guide supervisory action
- **Encouraging ERM** – The NAIC expects the ORSA to help foster effective ERM practices at all insurers

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The contents of the ORSA filing

Insurers will file the ORSA annually with their lead state regulator, and with other states on request

- Insurers will be expected to provide a summary ORSA report to their lead state commissioner annually. Other domiciliary state commissioners may also request the summary report.
- Insurers are expected to conduct the ORSA process regularly internally, and to maintain more detailed documentation of the risk management framework, ORSA process and results, which the supervisor may review as part of analysis or examination procedures.
- The filing of the summary report will be coordinated with the insurer's strategic planning process, in addition to any ORSA requirements to which an insurer is subject in other jurisdictions, so that the information is timely, and the process is not completed more than once annually.
- The ORSA may also be requested if an insurer's situation is troubled.

The guidance exempts smaller insurers, although states or regulators may still require the ORSA

- The NAIC's guidance includes the following exemption thresholds:
 - if the **individual insurer's** annual direct written and unaffiliated assumed premium*, including international direct and assumed premium, does not exceed **\$500 million**; and
 - if the **group's** annual direct written and assumed premium*, including international direct and assumed premium, and excluding affiliated reinsurance premium, does not exceed **\$1 billion**
- Where one or both of the threshold(s) is/are exceeded, the ORSA must be provided for the group and/or relevant legal entities
- A regulator may require any insurer to provide the ORSA, and any insurer may request a waiver, based on unique circumstances

*Excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program

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The ORSA guidance manual requires a 3-section structure for the ORSA summary report

Section 1 – Description of the insurer's risk management framework

- Section 1 provides a summary of the risk management framework and policies, aligned to the following principles:
 - Risk Culture and Governance
 - Risk Identification and Prioritization
 - Risk Appetite, Tolerances and Limits
 - Risk Management and Controls
 - Risk Reporting and Communication
- The level of detail should be appropriate to the nature and complexity of the company, and is not intended to be lengthy. Section 1 can reference more detailed internal documentation (e.g. risk policies), providing these are available to the supervisor on request

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The ORSA guidance manual requires a 3-section structure for the ORSA summary report

Section 2 – Insurer’s assessment of risk exposures

- Section 2 documents management’s quantitative, or where quantitative assessment is not feasible, qualitative assessment of risk exposures in normal and stressed environments. The section should include:
 - details of risks identified, measurement approaches used and assumptions
 - quantification of risk for each major risk category
 - outcomes of plausible adverse scenarios
 - the impact of stressed environments on available capital, considering multiple capital viewpoints if relevant (e.g. regulatory, rating agency)
- The structure of the assessment should reflect the way the business is managed in practice. Where appropriate or requested by the regulator, a group assessment may be mapped to legal entities

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The ORSA guidance manual requires a 3-section structure for the ORSA summary report

Section 3 – Group risk capital and prospective solvency assessment

- Section 3 explains how the assessment of risk is used to determine the financial resources the company requires to achieve its business objectives over its business planning period, considering normal and stressed conditions, and may include:
 - definition of solvency
 - accounting or valuation regime
 - time horizon of risk exposure
 - risks modeled
 - quantification method
 - measurement metric
 - target level of capital
 - aggregation and diversification
- The assessment should consider the group as a whole, including the impact of inter-group transactions and financing arrangements, the transferability and fungibility of capital, and contagion risk

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The ORSA guidance manual requires a 3-section structure for the ORSA summary report

Section 3 – Group risk capital and prospective solvency assessment

- The section should demonstrate that the organization has sufficient capital to execute its 2-5 year business plan, taking into account the potential impact of adverse scenarios, and should consider the company's own economic solvency needs in addition to regulatory capital requirements
- Where necessary, the section should detail the actions that management has taken or will take where capital may not be adequate, for example, modifications to the business plan, or the raising of new capital

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Initial feedback from the 2012 ORSA pilot

U.S. ORSA pilot initial feedback – ORSA will be a “game-changer”, but progress needs to be made

- Over summer 2012, the NAIC ran a pilot review using 13 ORSA Summary Reports submitted by a range of insurers. Initial feedback on results was provided at the Summer National Meeting in August 2012.
- Regulators expect the ORSA to change regulation of insurers significantly. However, they also expect insurers to need to develop their ORSA processes and reports significantly.
- Reviewers were impressed with some of the ORSA Summary Reports submitted, but felt that others needed to be developed further.
- The first required ORSA Summary Reports are expected to be submitted in 2015. The NAIC provided a strong message that the ORSA is not just a reporting requirement, and that insurers will be expected to evidence a sound ERM process.

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The NAIC plans to reflect 4 areas of feedback in the ORSA Guidance Manual

4 key observations from the pilot are expected to be reflected in the regulatory guidance used by insurers for the ORSA Summary Report:

1. The basis of accounting needs to be identified – regulators have not prescribed the basis of accounting used (GAAP, SAP, IFRS, etc), but expect insurers to be clear about the figures provided.
2. The scope of the ORSA needs to be explained – an organizational chart should be provided, and it should be clear which entities are covered by the Summary Report.
3. A summary of material changes since the last ORSA should be provided.
4. Both current year and prior year capital figures should be provided.

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Insurers are also expected to cover 17 areas of additional feedback in their Summary Reports

The following additional points of feedback were also provided by the NAIC. Regulators stressed that, while these points will not be in the Guidance Manual, insurers should consider them essential:

1. Comparatives should be provided.
2. Trends should be analyzed.
3. Results should be mapped to legal entities, and not just to business segments.
4. All terms and acronyms should be defined.
5. Specific details should be provided of what key and material risk limits an insurer uses.
6. Scenario analysis should be performed to assess multiple stresses in combination.

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Insurers are also expected to cover 17 areas of additional feedback in their Summary Reports

7. All tables, graphs and similar information should be explained.
8. The calculation of capital numbers, including use of any models, should be explained.
9. Risk heat maps should be provided.
10. A list of risk owners should be provided.
11. The link between risk and compensation should be explained. Regulators indicated that they consider this a significant issue.
12. Multiple measures of capital should be presented and compared (e.g. economic, rating agency), with measures other than RBC considered.
13. Backup documentation should be included to provide further detail.

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Insurers are also expected to cover 17 areas of additional feedback in their Summary Reports

14. Liquidity stress testing should be performed (in particular for life companies).
15. Significant focus should be placed on stresses to capital.
16. An executive summary should be provided for more complex insurers.
17. Emerging risks should be covered in the prospective risks section.

The NAIC expects to provide full written feedback on the results of the pilot in the next few months, and will then modify the ORSA Guidance Manual.

Regulators indicated that they may run a further pilot exercise next year, and will also provide recommendations for guidance for NAIC analysts and examiners.

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Systemically Important Financial Institutions (SIFIs)

What is a Non-Bank Financial Company SIFI?

SIFIs are viewed to pose systemic risks to the economy in a financial stress scenario. They will be overseen by the Federal Reserve in addition to being regulated by state authorities. As such, they will be subject to numerous prudential standards including rules on capital & liquidity, in addition to providing resolution plans. Bank Holding Companies are treated as SIFIs if they have \$50 billion or more in consolidated assets; same is true for Foreign Banking Organizations with a US branch or agency operations (FBOs) that have \$50 billion or more in global assets.



- A US NBFC must be “predominantly engaged” in financial activities permissible for Financial Holding Companies.
- To be “predominantly engaged” in financial activities, a US NBFC’s consolidated annual gross revenues from financial activities must be $\geq 85\%$ or have $\geq 85\%$ of consolidated assets related to financial activities.
- Prototypical NBFC SIFI is likely to be a major financial company with a significant presence in financial markets, that may or may not already be subject to Federal or state regulation

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Designation Standards

Non-bank financial institutions will be designated a SIFI if either of two standards are met:

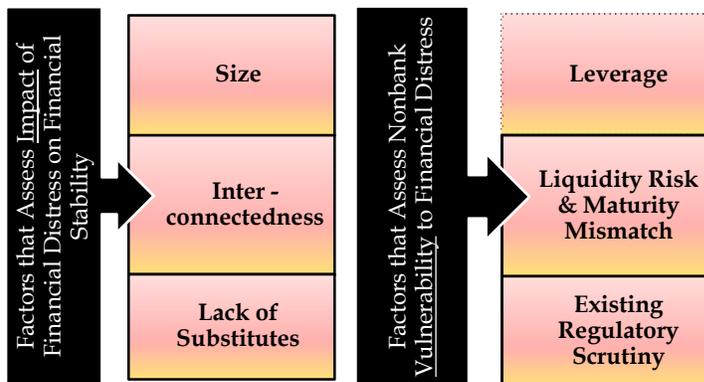
- If FSOC determines that “material financial distress” at the non-bank financial company could pose a threat to the financial stability of the US.
- If FSOC determines that the nature, scope, concentration, size, scale, interconnectedness, or mix of the non-bank financial company’s activities could pose a threat to the financial stability of the US.

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Designation Standards

To determine if the two standards are met, FSOC developed an analytic framework grouping all relevant factors, considerations, and any additional risk related factors into six categories. Factors 1, 2 and 3 seek to assess the potential impact of a NBFC's financial distress on the broader economy; factors 4, 5 and 6 assess the vulnerability of a NBFC to financial distress.



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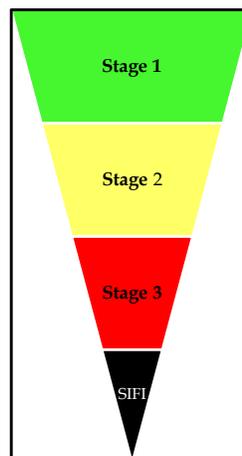
The Three Stage Approach

In using the established framework to carry-out the analysis, the FSOC will use a three-staged approach to evaluate companies across all industry sectors, in an attempt to harmonize the review process through set standardized criteria, commencing with a size threshold.

Stage One

To identify companies that will be subject to further review, a non-bank financial company must have at least \$50 billion in total consolidated assets AND meet with one or more of the following:

- Total of \$30 billion in gross notional credit default swaps outstanding for which the nonbank financial company is the reference entity.
- Total of \$3.5 billion in derivative liabilities.
- Total of \$20 billion in total debt outstanding.
- Leverage ratio of 15 to 1, as measured by total consolidated assets (excluding separate accounts) to total equity.
- Short-term debt ratio of 10% (having a remaining maturity of less than 12 months) to total consolidated assets (not including separate accounts).



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The Three Stage Approach

Stage Two

- The companies identified in Stage 1 would be analyzed and prioritized based on a wide range of quantitative and qualitative information, available from both public and regulatory sources.
- The internal review would be conducted in cooperation with the Office of Financial Research (OFR) prior to requiring the submission of reports from any non-bank.

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Stage Three

- After Stage 2, firms that the FSOC believes merit further analysis will receive a notice articulating that they are being considered for SIFI status and be requested to provide additional information. An evaluation of the firm's resolvability will also be conducted.
- Following the more in-depth review, if FSOC concludes a firm may be a SIFI, the company will be provided the opportunity to submit written materials contesting the determination.
- The company will have the right to testify at a hearing and request an additional vote of the FSOC at the conclusion of the hearing.

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Implications of SIFI Designation

- Enhanced prudential standards
 - Higher capital requirements
 - Early remediation framework
- Increased oversight
 - Mandatory submission of resolution plan
 - Federal Reserve supervision
- Limitations on growth (by acquisition)

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Global Systemically Important Insurers (G-SIIs)

Global Systemically Important Insurers (G-SIIs)

- IAIS asked by the G20 & Financial Stability Board (FSB) to recommend G-SII's. (Ultimate determinations to be made by G20 members.)
- Commissioned a data call earlier last year.
- Distinction was made between the traditional insurance business model and banking business model
- Recognition that insurance is founded on the law of large numbers
- Three step assessment methodology
 - Data collection
 - Indicator-based assessment of the data
 - Supervisory judgment and validation

G-SII Implications

Potential Policy Measures That Could be Applied:

- Enhanced supervision
- Removal of barriers to orderly resolution
- Higher loss absorbency levels
- Other supplementary prudential measures as determined by national authorities

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Conclusion

Thank you...

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