Email this Article

Black Swans

After AIG's near collapse, regulators wondered what more they could do to keep policyholders safe and prevent a similar catastrophic event from unfolding in the future. In the following package, *Best's Review* looks at the evolving regulatory environment—from the NAIC's ORSA and the Federal Reserve's proposed capital standards, to other developments such as principle-based reserving and growing protectionism in international markets.

by Kate Smith

CONTENTS

Black Swans	62
Staying Liquid	66
Building Fences	69
A Customized Approach	72
Setting Standards	76

Nassim Nicholas Taleb, a Wall Street trader turned writer, popularized his "black swan" theory after the global financial crisis. The term describes events that are extremely difficult to predict yet have catastrophic impact.

But while some might argue that the meltdown of 2008-2009 was a black swan event, U.S. regulators emerged from the crisis with a question: Could we have seen it coming?

For U.S. regulators, the financial crisis and near undoing of American International Group exposed a blind spot in the regulatory framework—the lack of group level supervision, as risky investments by a non-insurance entity, London-based AIG Financial Products, created the debacle.

"The contagion effects experienced by U.S. insurers in the AIG holding company system's near collapse prompted U.S. insurance regulators to reevaluate their group supervisory framework and pay closer attention to the risks created by activities going on outside of those entities as well as the reputational and contagion issues that could exist," the National Association of Insurance Commissioners stated in a brief.

To address the issue, the NAIC created the U.S. Own Risk Solvency Assessment (ORSA), which requires insurers of a certain size to analyze and report on the adequacy of their risk management

Kate Smith is a senior associate editor. She can be reached at *kate.smith@ambest.com.*

practices and holistically identify solvency risks.

ORSA went into effect in 2015; states have until the end of 2017 to adopt the model.

As ORSA approaches the two-year mark, experts say the new requirement has had a few glitches—most notably, concerns around confidentiality and how closely the filings are analyzed—but largely has unfolded with little resistance.

"It may be a surprising reaction to a new regulation, but most companies I've talked to have been very receptive to ORSA," said Chad Runchey, a principal in EY's Insurance Advisory Services. "If you boil it down, there's no argument that insurers should have a good risk management capability."

The Rollout

The smooth rollout largely has been due to the NAIC's three pilot programs—which provided insight into regulator expectations—and the loose framework of the requirement, which allows for customization of reports.

"The industry had plenty of runup," said Howard Mills, global insurance regulatory leader for Deloitte. "The NAIC had done a very involved pilot program, where companies could volunteer to participate. So there actually was more guidance offered than was originally talked about. In the early stages the regulators talked about this being very individualized, very holistic, and there would not be a template offered. But as they offered feedback on the pilot program, the industry started to get a sense of what types of things the regulators expected to see in their ORSA.

"The other thing that I think was very helpful is that, provided a company files an ORSA, they've met all of the requirements. There are no grades attached, if you will. Companies aren't given a deficient report from a regulator provided they've filed an ORSA. That may change over time, but I think the regulators have eased the industry into this effectively."

John Huff, NAIC president and Missouri insurance director, said regulators largely have been pleased with the early ORSA submissions.

"The vast majority of filings have closely followed the guidance outlined in the NAIC guidance manual," Huff said. "We have seen a range of variation in the level of detail provided in the filings. And overall, there has been some variation of the maturity of the enterprise risk management processes described in the submissions, which is understandable.

"We've also seen some companies experience some challenges in determining the scope and the extent of the ORSA. How comprehensive do they want to be in putting the filings together—both in terms of entities to be included and more importantly what risks should be addressed?"

"We have seen a range of variation in the level of detail provided in the filings. And overall, there has been some variation of the maturity of the enterprise risk management processes described in the submissions, which is understandable."

John Huff
National Association of Insurance Commissioners

The ORSA filings are meant to be individualized to the company.

"There's quite a bit of flexibility and room for customization in preparing the filings," Huff said. "That was intentionally done to encourage insurers to accurately report on their own enterprise risk management practices and their findings. That's the O in ORSA. We wanted to make sure companies weren't just filling out a form and doing something prescriptive; we want them to share what their own risk assessments are and then share what they already use, in some form, with their board or other external parties like rating agencies. So the non-prescriptive nature is important."

The Wrinkles

The ORSA is designed, experts say, to be like an internal report.

"At the outset ORSA was intended to be similar to the report that a company's enterprise risk management department or risk officer might create for delivery to its board, for the purpose of providing the board with an update on where the company stood with its management of enterprise risks," said attorney Michelle Rogers, director of financial and regulatory policy for the National Association of Mutual Insurance Companies. "But some companies have felt the need to design the ORSA report differently than they would their internal report to their board."

That's because there are some concerns around confidentiality of the filings.

"This is a sensitive set of information that companies will be providing," Rogers said. "It includes their business strategy and planning for the future. It includes the risks they must anticipate, but may not necessarily experience. It's a forward looking document that presents some very sensitive information.

"The fact that there are a few states that have not 100% adopted the ORSA confidentiality language leaves regulators and the industry with some open questions about whether they can share an ORSA with a state that doesn't protect it."

Companies file their ORSA in their state of domicile, but any state they write in can request a copy, Mills said. That gets sticky because there are divergent statutes around the ability of departments of insurance

to redact what a company considers to be proprietary information.

"The concern you hear most often is about the state of Florida, which is a very consequential state," Mills said. "Most companies, if they're anything close to a national company, will write in Florida. But Florida doesn't have the statutory authority, under their constitution, to redact information. Anything on file is subject to Freedom of Information requests. So if you write in Florida, you're subject to any number of states requesting the ORSA. People feel that's your Achilles' heel, that some of your information can get out."

New York is also of concern, Rogers said.

"In their adoption of ORSA by regulation instead of by law, there is a question raised as to whether regulation could supersede a Freedom of Information Act request," she said. "Even if the regulation has confidentiality language, would that actually supersede it?"

There also have been questions about whether regulators have the staff and expertise to meaningfully evaluate the filings.

"Some companies are questioning whether these are really being used," Mills said. "'What is my regulator doing with the ORSA? Do they have the resources and the technical expertise to take this and understand it and really analyze it in a way where they get insights?' That's something that is being questioned, and not all departments of insurance are created equal. Some don't have the same staff and expertise as others. So there are some skeptics out there who feel they went through all this time, effort and money. 'And what did we get out of it?' That's a legitimate concern, because there's definitely a cost to doing these."

The NAIC is addressing insurers' concerns by training states in how to evaluate an ORSA and putting together best practices for how confidentiality should be handled.

"That's helpful," Rogers said. "It's a good start."

"This is a sensitive set of information that companies will be providing. It includes their business strategy and planning for the future. It includes the risks they must anticipate, but may not necessarily experience."

Michelle Rogers
National Association of Mutual Insurance Companies

The Reaction

Despite those concerns, the ORSA has been well-received overall.

"Because there is flexibility in the regulation, there isn't a whole lot to argue with," EY's Runchey said. "If you look at what the ORSA is asking you for, there is not a lot to argue with. Section 1 is asking you to describe your risk management framework. Section 2 is asking how you understand your risk exposures. Section 3 looks at your risks and your business plan under stress. All of those are good core risk management capabilities and not very controversial.

"This is about putting risk management more in the forefront," Runchey said. "Prior to this, there wasn't an explicit requirement around risk management. Now it is front and center in the ORSA. The ORSA is all about how you manage risk. For companies that have more sophisticated risk management frameworks in place, they were already proactively looking to be more prepared for the next crisis and understand how to mitigate the impact to the company. The ORSA has formalized that process a little bit more. Where companies didn't have a forward-looking stress testing capability in place, this new requirement will help them better manage their risk."

Forward-looking stress testing is new to the industry.

"Historically it's been point-in-time solvency assessments," Runchey said. "This changes that a little by saying, 'Let's look forward over the next three to five years. What is your business plan? What is your future capital or solvency position? And how does that look under stress?'

"Without drawing parallels to the level of rigor that's expected, it's similar in concept to the Federal Reserve stress testing that the banks are subject to," Runchey said. "If you go to the banking side, the requirement is a forward-looking view of your future capital positions under base and stress conditions. The level of rigor the Federal Reserve expects out of that analysis is significantly more than what's needed for the ORSA, but the concept is similar."

Namic's Rogers said the ORSA has benefits for both insurers and regulators.

"This is an exercise in self-awareness for companies," she said. "And it's also an exercise for the regulators in a new style of regulation, where they are considering the challenges that the company is considering and understanding the company better as opposed to looking for negatives.

"I'm really pleased by the approach to it—that it isn't being looked upon as a pass or fail situation," Rogers added. "ORSA is a unique tool and a unique program in that companies are encouraged to develop their risk management in the way that best suits their individual needs and the risks that they face and that works best in their corporate environment. That is something we haven't seen often in regulation." BR