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"Evolution of the Actuary in Financial Condition Examinations of Insurance Companies"

True or False Questions — Submit Answers Online

1. One change caused by the risk focus approach, for the actuary, is to increase the time spent in detailed reserve testing to ensure they are correct.
2. Risk mitigation strategies for reserves are considered by the examiner not the actuary.
3. Low residual risks do not result in substantive testing.
4. Substantive testing, in some cases, can be accomplished by reviewing the actuarial work papers completed by the company's opining actuary.
5. Claim handling practices is a risk concern to the actuary.

" Critical Risk Categories for Financial Examinations "

True or False Questions — Submit Answers Online

6. The critical risk categories will ensure a maximum standard of quality in the identification of solvency risks.
7. For exams with a year end of 12/31/2012, the requirement that at least one risk statement be prepared for all line items above TE, is removed.
8. One issue noted in the article involved examination teams identifying potentially critical solvency risks during planning but then not doing enough to determine whether solvency risks had been mitigated appropriately.
9. Exhibit E has normally been used to assess the internal and external audit functions. Now it will allow examiners to determine whether a review of financial reporting risk can be reduced based upon the effectiveness of the audit function.
10. If any of the 10 critical risks on Exhibit DD is not applicable to the company under examination, it can be ignored.

CRE READING PROGRAM QUESTIONS

(continued)

All quizzes MUST be taken online

" NAIC ORSA Implementation for Companies "

True or False Questions — Submit Answers Online

11. The NAIC's Risk Management and Own Risk Solvency Assessment (RMORSA) Model Act becomes effective January 1, 2015.

12. The NAIC defines solvency as a means to ensure that legal obligations to policyholders, contract holders, and others are met when they come due, insurers are required to maintain reserves and capital and surplus at all times and in such forms so as to provide an adequate margin of safety.

13. The ORSA concept requires every insurance company to carry out a regular assessment of all of its risk in a single department and evaluate its past solvency position.

14. Compliance with the RMORSA Model Act will be standard among insurers in a "one-size-fits-all" approach and does not need to be tailored to the individual insurer.

15. Insurers domiciled within the United States are exempt from the NAIC's RMORSA Model Act compliance if an individual insurer has less than $500 million or an insurance group has less than $1 billion in annual direct written premium and unaffiliated assumed premium and the state insurance commissioner does not require insurer compliance.

"The Increasing Importance of Sound Operational Risk Management"

True or False Questions — Submit Answers Online

16. The International Association of Insurance Supervisors (IAIS) defines Operational risk as the adverse change in the value of capital resources resulting from operational events.

17. Operational risk is not considered a distinct risk category.

18. The three risk categories that are used in Pillar 1 of Basel II are Credit Risk, Operational Risk and Liquidity Risk.

19. Operational risk is difficult to identify and assess at organizations.

20. Operational risk is currently a factor in the RBC calculation.

Evolution of the Actuary in Financial Condition Examinations of Insurance Companies

By Ben Conrad
Bartlett Actuarial Group

In recent years, the actuary's role in financial condition exams has been evolving into a more comprehensive part of the examination process. The main objective of financial condition exams has always been to evaluate the solvency of the company. Traditionally, in support of this objective, the scope of the actuary's work would often be limited to a retrospective review of company reserves. The remainder of the examination would usually be left to the examiner, including the assessment of company operations, claims handling practices, reinsurance considerations, premium collection methods, etc. State departments of insurance have been transitioning to a new type of evaluation: the risk-focused examination. With the advent of the risk-focused examination, the role of the actuary has transformed.

With traditional financial condition examinations, the actuary's role was typically limited to an objective review of company reserves. The actuary would be contracted by the department to perform an independent detailed reserve analysis and provide an opinion on the overall reserve. Other duties of the actuary could have included a full detailed review of the opining actuary's report and opinion to determine if the opining actuary's methods and assumptions were appropriate. Once the final reserve report and opinion were submitted, the actuary's involvement would usually end. The risk-focused process necessitates much more interaction between actuary, examiner and company as everyone works together to evaluate the current and future risks and risk controls of the company. The necessary teamwork in this endeavor enhances communication resulting in a better understanding of the company and helps the actuary understand exactly what the examiner expects throughout the examination process. The introduction of the risk-focused examination has changed the scope of the actuary's work to increase the time spent evaluating the company as a whole and decrease time spent focusing on detailed reserve testing.

In April 2013, the NAIC and several state department actuaries presented a webinar designed to outline the actuary's present role in risk-focused examinations. This webinar described the restructured responsibilities of the actuary and how the actuary fits into each phase of the examination. The key elements of these restructured actuarial responsibilities are

- Review is much broader in scope and is expanded to reserves, pricing, liquidity and reinsurance
- Substantive Testing is limited to moderate or high risk areas
- Internal controls about the reserving process are evaluated before the detailed reserve analysis
- Risk mitigations strategies are considered by the actuary

Evolution of the Actuary in Financial Condition Examinations of Insurance Companies

(continued)

These responsibilities can be grouped into two sequential processes. The first core responsibility of the actuary encompasses a broad analysis of company risks and corresponds with the first four phases of the NAIC Financial Condition Examiners Handbook. This process involves evaluating which risks the company faces with regard to the collection and treatment of premiums, reinsurance considerations, claims handling practices, and actuarial reserving methods. Once these risks are identified, the actuary must consider the risk mitigation strategies employed by the company to control each of the risks. These risks and controls are identified and evaluated by the actuary with continuous communication between the actuary and the examiner. This first core responsibility ends with a coordinated effort between the actuary and examiner to label each risk as 'low,' 'moderate,' or 'high.'

Next, the actuary is responsible for a complete and detailed testing of selected risks. While traditional examinations focused on the detailed testing of carried reserves only, the substantive testing of the risk-focused exam typically extends to any risk identified as 'moderate' or 'high' in the risk analysis portion of the exam. This substantive testing could apply to any area of the business viewed as a concern for the examination team. Although detailed independent actuarial analysis may be warranted for many risks, in some cases the substantive testing can be accomplished by performing an in-depth review of actuarial work papers completed by the company's opining actuary. This in-depth review may include independent analysis of the opining actuary's methods such as sensitivity testing, development factor analysis, or other function of the analysis. By focusing their scope, the actuary can spend more time evaluating the areas of true concern as part of the examination team.

These responsibilities demonstrate how the evolution of the actuary in financial condition exams has begun to intertwine the scope of the examination for the actuary and the examiner. What was once an identifiable separation between responsibilities is now an overlapping effort that results in a more thorough examination process through added teamwork and communication. The added level of interaction throughout the examination process allows both the actuary and examiner to better understand the company as a whole, and in doing so creates a level of transparency that provides a better overall picture of current and future solvency concerns. As the actuary's role continues to evolve, I believe we will continue to see improvements in the examination process which will allow the state departments of insurance to better understand the financial solvency at the company level and for the insurance market as a whole.

Evolution of the Actuary in Financial Condition Examinations of Insurance Companies

(continued)

Ben Conrad joined Bartlett Actuarial Group in January of 2012 as an Actuarial Analyst. Ben graduated from Florida State and began his career at the Florida Department of Insurance. Ben specializes in assisting states on financial condition examinations of insurance companies and has worked with the states of Michigan and Pennsylvania. Ben also provides analytical assistance for clients by developing the mathematical models that help clients quantify, evaluate, and manage the costs associated with their insurance programs. Ben has worked on risk focused exams and was intrigued by the changing role of the actuary on examinations which inspired him to write this article. Ben can be reached at **benc@bartlettactuarialgroup** or at **843-377-0993**.

Critical Risk Categories for Financial Examinations

By Becky Meyer, CPA and Kevin Roe
National Association of Insurance Commissioners (NAIC)

From the time the risk-focused examination approach was implemented, progress has been monitored by various working groups of the NAIC. Over the past two years, the Risk-Focused Surveillance (E) Working Group (RFSWG) has utilized an Examination Peer Review Program to monitor risk-focused implementation, identify exam best practices, and recognize areas needing improvement. Some of the most concerning observations coming out of recent Peer Review sessions have frequently involved occasions where examiners identified potentially critical solvency risks during planning, but then did not perform a sufficient amount of exam procedures to determine whether risks had been mitigated to an acceptable level. As it appeared evident that specific attention was needed to help examiners identify and address key solvency concerns, the findings of the Peer Review Program have led the RFSWG to take action for identifying a solution to aid examiners in improving examinations.

In reaching a solution to help limit findings of this nature, focus was placed on reducing time spent on unnecessary financial statement verification to provide increased flexibility for examiners to focus on the most critical issues. This has resulted in the removal of the requirement for all line items above tolerable error (TE) to be addressed by a risk statement. The removal of this requirement will be applicable for exams with an 'as of' date of 12/31/2013 or later.

In addition, to ensure examiners are focusing time on the most significant solvency related risks, Exhibit DD – Critical Risk Categories was developed. Exhibit DD lists 10 of the most common critical risk categories found at insurance companies that can often represent significant threats to a company's overall solvency position. Each category is considered to be a potentially critical solvency risk that an examiner would generally be expected to address as a risk to most companies. The critical risk categories will serve as the minimum standard for accreditation purposes beginning for examinations with an 'as of' date of 12/31/2013 or later.

Exhibit DD is intended to provide the exam with a clear link between each critical risk category and a risk statement (contained on a risk matrix or on Exhibit V). The mapping between risk statements identified for review in the examination and the critical risk categories is required to be documented on the exhibit. For situations where a critical risk category is not considered applicable to the company, the examiner should provide a brief explanation in the planning memo. For situations where multiple risks are necessary to fully address a critical risk category, each applicable risk statement should be mapped to that critical risk category on the exhibit.

Critical Risk Categories for Financial Examinations

(continued)

It is expected that the critical risk categories will allow for consistency among examinations and ensure a minimum standard of quality in the identification of solvency risks. However, Exhibit DD is not intended to drive the key activity or risk identification process. In fact, examiners are expected to identify key activities and individual risk statements before completing Exhibit DD at the end of Phase 2. Mapping to the critical risk categories at the end of Phase 2 will help to determine if there were any critical risk categories not addressed on a risk matrix or Exhibit V. This progression will allow examiners to customize risks accordingly, to ensure that all relevant significant solvency issues are reviewed for a particular examination.

There has been some hesitancy amongst regulators to remove the requirement to address items above tolerable error with a risk statement. In fact, with the removal of this requirement, the examination process may reduce its focus on line item reporting, thus increasing the importance of determining whether an effective audit function is in place at the insurer. Therefore, there have been some changes to Exhibit E – Audit Review Procedures to allow examiners to exercise a level of reliance on the insurer's audit function commensurate with its effectiveness. The examiner has traditionally used Exhibit E to assess both the internal and external audit functions and determine reliance that can be placed on these functions. The conclusion for Exhibit E will now allow examiners to determine whether a review of financial reporting risks can be reduced based upon the effectiveness of the audit function. This assessment and any necessary support required to reach this assessment is heavily reliant on examiner judgment.

The upcoming changes to the *Financial Condition Examiners Handbook* will ultimately allow increased flexibility, quality, and efficiency for exams in the near future. This guidance was developed in a large part from leveraging knowledge and experience of the examiners who participated in the Peer Review Program. This is because it is important to develop examination guidance using input from the people who will use it on a daily basis.

In October and November 2013, the NAIC held a webinar introducing these concepts in more detail. This webinar will be archived and available on demand through the Handbook Updates webpage which is linked to both StateNet and the Financial Examiners Handbook (E) Technical Group webpage. As implementation of this new approach is still in its infancy, there will likely be development of additional training and sound practices to ensure examiners are able to successfully adapt to the added flexibility and increased level of responsibility in financial regulation.

Critical Risk Categories for Financial Examinations

(continued)

With the implementation of the critical risk categories comes the hope that examination teams will use the additional flexibility and judgment provided to more fully address the risks most critical to a company's ongoing solvency. In doing so, examiners engage in effective financial regulation and continue to serve the needs of the policyholders and protect the public interest.

For questions regarding the critical risk categories and newly adopted guidance, please contact the NAIC examination staff:

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NAIC Risk Management and Own Risk and Solvency Assessment (RMORSA) Model Act Implementation for Insurance Companies

By Bonnie A. Cottle-Casella
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Abstract

This article will examine domestic and global insurer solvency requirements with a primary focus on the United States' National Association of Insurance Commissioners' (NAIC) Risk Management and Own Risk and Solvency Assessment (RMORSA) Model Act. In addition, this article will provide industry guidance to small through midsized insurance companies that have recently breached or are close to reaching the $500 million of annual direct written and unaffiliated assumed premium. Insurance companies can use this information to develop an Enterprise Risk Management (ERM) framework based upon the International Association of Insurance Supervisors' Insurance Core Principles (ICP) 16 on Enterprise Risk Management and NAIC's Own Risk and Solvency Assessment (ORSA) Guidance Manual. In order to provide insurance companies an outline of ORSA, the review will include the European Union's Solvency II Directive, International Association of Insurance Supervisors' Insurance Core Principles (ICP) 16 on Enterprise Risk Management, and the NAIC ORSA Guidance Manual as well as the different perspectives of (1) Solvency; (2) Enterprise Risk Management; and (3) Own Risk and Solvency Assessment.

Keywords: *Own Risk and Solvency Assessment, ORSA, Solvency, NAIC, Enterprise Risk Management, ERM, ORSA Guidance Manual, ICP 16*

Introduction

Insurance companies have a responsibility to their subscribers, members, policyholders, and other stakeholders to uphold the promise to provide benefits and pay claims as outlined by individual insurance policy contracts. Given this level of responsibility, and recent economic collapse in the late 2000's, insurance companies domiciled within the United States that exceed specific levels of annual direct written and unaffiliated assumed premiums, are required to be compliant with individual states' versions of the National Association of Insurance Commissioners' RMORSA Model Act. This Model Act becomes effective January 1, 2015. The objective of the solvency assessment is for insurers to develop, implement, and utilize on an ongoing basis, risk management, and solvency reviews. Such reviews are to be conducted under both normal as well as stressed environments to ensure that insurers have adequate levels of capital.

The RMORSA Model Act is primarily the result of the NAIC's Solvency Modernization Initiative (SMI) which began in June 2008. The SMI timeline was quickened due to the economic collapse occurring around this time and the NAIC did not wait to improve its oversight on group insurers. Pennsylvania's Deputy Insurance Commissioner, Steve Johnson , explained that the NAIC swiftly responded to the economic collapse with expanding the Insurance Holding Company System Regulatory Act and the Insurance Holding Company System Model Regulation. The expansion included the newly created Form F, requiring prior approval for insurance company transactions, and placing more responsibility on the company's board. Because of the economic

collapse and SMI's quickened timeline, a NAIC task force was developed and charged with the responsibility to devise guidance for the RSMORSA Model Act. The RSMORSA Model Act includes a "critical self-examination to update the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation."

On September 6, 2012, the Financial Condition (E) Committee of NAIC adopted principles based RMORSA Model Act. In addition, NAIC established the ORSA Guidance Manual in 2011. This guidance manual outlines how insurers are to report on the insurer's RMORSA compliance. Currently this manual has been revised as insurers provide feedback and participate in pilot studies from its original form in 2011 to the current March 2013 version. The pilot studies included several insurers who prepared ORSA Summary Reports for insurance commissioner's review and feedback. NAIC's RMORSA Model Act is among other solvency initiatives that have been developed globally. Three key solvency initiatives have developed occurred globally. The Group of Twenty (G20) Summit on Financial Markets and the World Economy presented a Declaration on November 15, 2008, which summarizes the need for developing solvency regulations, laws, and directives. The Declaration acknowledges that many countries have had to take urgent measures to support the economy and stabilize the financial markets globally as well as the need for reform to ensure that the economic collapse does not happen again.

Next, on November 25, 2009, the European Union adopted a rules based Directive on Insurance and Reinsurance commonly referred to as Solvency II. In addition to the efforts of the European Union, the International Association of Insurance Supervisors established a rules based approach in 2010. This group developed an enterprise risk management framework through the use of the ICP 16 on Enterprise Risk Management. ICP 16 is among other enterprise risk management frameworks, however will be reviewed within this paper.

The objective of this paper is to investigate the similarities and difference between the declarations, directives, principles, and model acts as each individual document applies to NAIC's RMORSA Model Act. Although the NAIC distinctively distances RMORSA from other models, reviewing other models, regulations, declarations, and directive will provide assistance in understanding the RMORSA Model Act and ORSA.

NAIC Risk Management and Own Risk and Solvency Assessment (RMORSA) Model Act Implementation for Insurance Companies

(continued)

Literature Review

Undeniably, the economic events occurring over the past several years with insolvency have left a lasting impression on many. Since these insolvency events occurred, regulators have reviewed them and set forth new regulations, directives, and acts to mitigate future insolvencies in order to protect consumers. Research was performed to determine appropriate recommendations for insurance companies to implement NAIC's RMORSA Model Act. The RMORSA Model Act is principles based and provides guidance rather than imposing specific rules, requirements, and methods to comply with the Model Act. Currently, research over the implementation of NAIC's RMORSA is limited to regulation language, feedback from regulators on the initial pilot, and industry whitepapers.

Solvency defined within the business community. Solvency is critical in business as it is an indication of the financial state of the business. Solvent businesses have the ability to meet long-term financial obligations. In insurance, solvency represents the insurer's ability to meeting its financial obligations to policyholders when due. The International Association of Insurance Supervisors' (IAIS) ICP 16: Enterprise Risk Management further explains that "…the insurer should consider its solvency position and its risk tolerance. [Risk] limits should be set after careful consideration of corporate objectives and circumstances… without endangering the capacity of the insurer to meet its commitments to policyholders."

The European Union's Solvency II Directive defines solvency as policyholder protection that occurs as a result of the efficient allocation of capital. One objective of the Directive is to provide better protection for insurance policyholders. Lastly, when NAIC's RMORSA Model Act was adopted by the Financial Condition (E) Committee, it did not specifically define solvency. However, the NAIC does provide a general definition of solvency. The NAIC defines solvency as a means "to ensure that legal obligations to policyholders, contract holders, and others are met when they come due, insurers are required to maintain reserves and capital and surplus at all times and in such forms so as to provide an adequate margin of safety". While there are differences between ICP 16, Solvency II, and RMORSA's solvency definition, the solvency objective is similar.

Enterprise Risk Management. ERM is one of several highly discussed concepts with insurance industry executives and respective boards of directors and audit committees. The IAIS defines ERM as a combination of "several different terms… commonly used to describe the process of identifying, assessing, measuring, monitoring, controlling, and mitigating risks". ERM is a critical component to the implementation of NAIC's RMORSA Model Act as indicated in the NAIC ORSA Guidance Manual. The Guidance Manual states that ORSA is only a portion of an insurer's ERM framework.

NAIC Risk Management and Own Risk and Solvency Assessment (RMORSA) Model Act Implementation for Insurance Companies

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Research indicates that many companies do not have a robust ERM framework in place. The data of three surveys were reviewed for the purpose of this analysis. The Institute of Internal Auditors, an international professional association, presented the KPMG Audit Committee Institute's Public Company Audit Committee Member Survey results. Two hundred-fifty (250) Audit Committee members responded to the survey. The results revealed that 105 respondents, or 42%, indicated that their company's risk management system requires "substantial work." Furthermore, the results indicated, "a gap in organizations' proficiency in, or attention to, managing and overseeing risks."

Comparative data was presented during the 2013 - 2nd Quarterly Insurance Industry Update meeting. It was presented that only 28% of respondents to the Report on the Current State of Enterprise Risk Oversight and Market Perceptions of Committee of Sponsoring Organizations of the Treadway Commission's (COSO) ERM Framework described their "current state of ERM implementation as 'systematic, robust and repeatable with regular reporting to the board".

Lastly, IBM Corporation conducted a survey of United States Life and Health and Property and Casualty senior risk officers at insurance and reinsurance companies to determine readiness for ORSA. The results revealed that 23% of the respondents indicated that their company's ERM framework is not fully defined and 44% indicated their approach is defined but not fully implemented respectively.

The IAISs' ICP 16: ERM, although prescriptive and rules based, provides details on areas to consider as insurer's implement the ERM framework. ICP 16 defines enterprise risk management and outlines a method for risk identification as well as measuring, analyzing, and modeling the level of risk. ICP 16 defines ERM as including "the self-assessment of all reasonably foreseeable and relevant material risks that an insurer faces and their interrelationships." ICP 16 further provides guidance on the level of needed documentation, implementation of a risk management policy, development of a risk tolerance statement, responsiveness to risk profile changes, ORSA, necessary economic and regulatory capital, need for continued analysis, and defines the supervisory role of risk management.

NAIC Risk Management and Own Risk and Solvency Assessment (RMORSA) Model Act Implementation for Insurance Companies

(continued)

The European Union's Solvency II Directive does not specifically name ERM within the Directive. However, the Directive presents a rules based approach to providing "general provisions for the solvency capital requirement using the standard formula or internal model [,]… solvency capital requirement standard formula [, and]… solvency capital requirement full and partial internal models" in Chapter VI, Section 4, Subsections 1-3. Article 101, "Calculation of the Solvency Capital Requirement," outlines requirements for insurers, including reinsurers, similar to those of ICP 16. Within Article 101, paragraph 2 states the "Solvency Capital Requirement shall be calculated on the presumption that the undertaking will pursue its business as a going concern." Furthermore, in the Directive's Article 101, requires of the solvency capital requirement calculation to include insurer consideration of all applicable quantifiable risks, includes current business from the perspective of unexpected losses as well as consideration for new business 12 months into the future.

The Directive further states that the Solvency Capital Requirement will include, at a minimum, non-life, life, and health underwriting risk as well as market, credit, and operational risk that includes legal and reputational risk. It is also noted that when calculating the Solvency Capital requirement, the insurer should consider the effect of its risk-mitigation. The risk considerations of within the Directive are consistent to those used within the insurance industry.

NAIC's RMORSA Model Act as adopted by Financial Condition (E) Committee outlines ERM as that the insurer will maintain a risk management framework that provides assistance to the insurer in order to identify, assess, monitor, manage, and report its material and relevant risks. The RMORSA Model Act furthers outlines the ORSA Summary reporting requirements of ERM to include the signature of the insurer's chief risk officer or executive responsible for the oversight of the insurer's ERM process as an attestation to the best of their belief that the "knowledge that the insurer applies the enterprise risk management process described in the ORSA Summary Report and that a copy of the report has been provided to the insurer's board of directors or the appropriate committee thereof."

NAIC Risk Management and Own Risk and Solvency Assessment (RMORSA) Model Act Implementation for Insurance Companies

(continued)

While the RMORSA Model Act is vague in comparison to ICP 16 and Solvency II, the objective of insurers considering risks and calculating adequate level of capital under normal and stressed environments remains the same. Insurers have the option to determine which pre-established ERM framework to implement or develop the insurer's own ERM framework in order to fit the needs of the company. This allows regulators to look out the front window to see how insurers identify and manage risk rather than look at events that have already occurred.

Own Risk and Solvency Assessment. The term ORSA is utilized within both European Union's Solvency II Directive and NAIC RMORSA frameworks and yet they have different means of achievement. D. Tessier said, "The ORSA concept requires every insurance company to carry out a regular assessment of all of its risk company-wide and evaluate its current and likely future solvency position. The purpose of implementing an ORSA requirement is to help regulators understand how insurers identify, assess, monitor and mitigate risk." Wickland and Christopher noted that the NAIC has "been hesitant to follow the regulatory path set in Europe, primarily citing their disinclination to rely on internal models to calculate regulatory capital. However… [the Commissioners] consistently supported Solvency II's emphasis on risk management and governance and, in particular, the ORSA process."

The rules based approach of European Union's Solvency II Directive presents specific requirements in order to be in compliance with the Directive. The Directive states that all insurers should have a "regular practice of assessing their overall solvency needs with a view to their specific risk profile (own-risk and solvency assessment)."

Article 45 of the Directive, specific to ORSA requires the following for compliance with ORSA to include:

(a) the overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the undertaking;

(b) The compliance, on a continuous basis, with the capital requirements…;

(c) The significance with which the risk profile of the undertaking concerned deviates from the assumptions underlying the Solvency Capital….

NAIC Risk Management and Own Risk and Solvency Assessment (RMORSA) Model Act Implementation for Insurance Companies

(continued)

The principles based approach of the NAICs' RMORSA Act defines ORSA as a "confidential internal assessment, appropriate to the nature, scale and complexity of an insurer…, [including] the material and relevant risks associated with the insurer ['s]… current business plan, and the sufficiency of capital resources to support those risks." Furthermore, the RMORSA Model Act states the insurer will regularly conduct an ORSA as outlined in the ORSA Guidance Manual no less than annually but at any point when the insurer identifies significant changes to its risk profile.

Due to the principles based approach of ORSA, compliance with the RMORSA Model Act will vary among insurers and should be tailored to the individual insurer. Ingram noted there is "no one-size-fits-all approach to an ORSA and company risk policies, procedures and management actions should differ according to the business strategy and risks." The article further notes an ORSA requirement as such that the management and board of directors must evaluate the "adequacy of the firm's ERM system and capital, based on their own assessment of the firm's future plans, risks and risk capacity." Further review of the NAIC ORSA requirements is outlined below.

NAIC ORSA. Insurers domiciled within the United States are exempt from NAIC's RMORSA Model Act compliance if an individual insurer has less than $500 million or an insurance group has less than $1 billion in annual direct written premium and unaffiliated assumed premium and the state insurance commissioner does not require insurer compliance. Insurers that are not exempt will be required to be compliant as of January 1, 2015. Compliance with the RMORSA Model Act includes the implementation and ongoing monitoring of an ERM framework and ORSA assessment, which are presented in the insurers' ORSA Summary Reports. It is important to note that although there are over 4,000 insurers within the United States, the RMORSA Model Act based upon premium requirements will only require compliance for a small percent of insurers. Despite this small percent of insurers complying with the RMORSA Model Act, the RMORSA Model Act will include between 85-90% of all written premium within the United States.

The NAIC ORSA Summary Report requires insurers to present, in three sections, a description of the insurer's ERM framework, insurer's assessment of risk exposure, and a group assessment of risk capital and prospective solvency assessment. IBM Corporation highlighted the requirements of each section as follows:

- *Section One* – The insurer will present its ERM Framework and address "Risk Culture and Governance, Risk Identification and Prioritization, Risk Appetite, Tolerances and Limits, Risk Management and Controls, and Risk Reporting and Communication."

- *Section Two* – The insurer will address the "quantitative assessment of risk" as well as outline types of scenarios that for example "products with embedded guarantees would most likely require the use of stochastic scenarios, whereas simple products could potentially use deterministic scenarios."
- *Section Three* – The insurer will address how risk capital is calculated and determined at an enterprise level. In addition, the "Prospective Solvency Assessment should demonstrate that the insurer has enough capital to execute its business strategy over the planning horizon."

Providing the insurance commissioner with the ORSA Summary Report as previously outlined is an annual requirement. It is the expectation of insurance commissioners that the report will be scaled to the insurer and develops overtime.

While the recent economic events provide a need to implement a solvency framework such as NAIC's RMORSA Model Act, a majority of insurers are currently unprepared based upon statistics and surveys. Given the insurer's responsibility to subscribers, members, policyholders, and other stakeholders to uphold the promise made through the insurance policy contract, a solvency framework is needed in today's economic environment to determine adequate insurer risk appetite, needed capital under normal and stressed environments, and to provide regulators with forward thinking documentation to review the insurers' ongoing solvency.

Enterprise Risk Management Framework Selection

The RMORSA Model Act requires an insurer to maintain a risk management framework, however; the choice of framework is dependent upon the insurer. Insurers may select from, for example, the COSO ERM Integrated Framework, ICP 16, ISO International Standards 31000, OCEG Red Book 2.1, or an internally developed framework. For the purpose of this paper, this section will focus on the ICP 16 ERM Framework. However, is noted that each model has different benefits and the insurer should evaluate the frameworks prior to implementation.

ICP 16 ERM Framework. The IAIS developed ICP 16, which is a "comprehensive statement of principles and objectives that includes risk management philosophy, risk statement, solvency assessment (ORSA), identification of economic and regulatory capital, continuity analysis, and annual update", as noted by Romano and Schmoyer. IAIS's ICP 16 outlines a method for risk identification for an insurer's ERM that includes identifying and addressing "all reasonably forseeable and relevant material risks" that would include risks in underwriting, claims, expense and reserving, market, credit, operational, liquidity, legal, and reputational risks." Although it is a challenge to quantify reputational risk, the insurer should consider the impact that, for example, catastrophes and credit agency downgrades would have on collateral calls and policyholder terminations that could further impact liquidity.

Under the ICP 16 ERM framework, insurers should "consider the causes of different risks and their impacts and assess the relationship between risk exposures" as well as consideration to external risk factors. The results should provide the insurer with its strengths and weaknesses in governance as well as outline areas of internal controls, risk management policies, and organizational structure improvements. Insurers should review the correlation between the tails of risk profiles that for example risks under normal economic conditions show no strong connection yet have a stronger connection under catastrophic and market risks.

Insurers, under ICP 16, are required to document the measurement of risk with "accurate documentation providing appropriately detailed descriptions and explanations of risks, the measurement approaches used and the key assumptions made." Furthermore, insurers must have a documented risk management policy that outlines processes for the management of all relevant and material risk categories for the insurer's day-to-day operations as well as strategic business plans. The risk management policy must also describe the "relationship between the insurer's tolerance limits, regulatory capital requirements, economic capital and the processes and methods for monitoring risk."

In order to coordinate the "management of risks associated with assets and liabilities,… [insurers should include an asset-liability management (ALM) policy. The policy should set [… out how the investment and liability strategies adopted by the insurer allow for the interaction between assets and liabilities, how the liability cash flows will be met by the cash inflows and how the economic valuation of assets and liabilities will change under an appropriate range of different scenarios."Furthermore, the risk management policy should include an investment policy that outlines that specifies the nature, role, and extent of the investment activities as well as means to comply with regulatory investment requirements. The investment policy should include the following:

- Strategy for optimizing investment returns, specific asset allocation strategies, authorities for investments, and relate the investment policy to ALM.
- Consideration for risky financial instruments that include, but not limited to, derivatives and alternative investment funds.

Investments are of utmost importance and therefore, the policy should include stress testing and contingency planning for the stressed conditions.

One subsection of the risk management policy or a separate policy must address underwriting risk. Included in this policy must be the topics of the "underwriting process, pricing, claims settlement both in terms of timing and amount and expense control aspects of managing the risks… "Considering the claim timing and size uncertainty, underwriting risks should be addressed

in the ALM policy. In addition, the insurer should address reinsurance and its approach to risk transfer. The insurer should determine its level of risk as well as the level of risk it will transfer on its book of business.

In addition to the risk management policy, the insurer must develop a risk tolerance statement that address both quantitative and qualitative risk tolerance levels and defines how the insurer will define acceptable limits. The risk tolerance statement must also indicate how the insurer will use risk tolerance levels in both business plans and day-to-day operations. This statement should also guide the work of management and determine the level of risk the insurer is able to tolerate.

Upon completion of the insurer's ERM framework, the insurer should note that ongoing maintenance of the framework is required to the extent that the framework and risk management policy is responsive to change in internal and external events. Because the business environment is constantly changing, the insurers ERM framework should incorporate new identified risks on an ongoing and consistent basis. Examples of internal changes include new acquisitions, change in investment positions, and increase or decrease in lines of business. External changes include, for example, changes in regulations, rate agency, political, and major catastrophic event occurrences. The insurer must incorporate a feedback loop to ensure that the "decisions made by the board and senior management are implemented and their effect monitored and reported in a timely and sufficiently frequent manner via good management information." By engaging in all of these activities, the insurer's ERM framework remains relevant in meeting the insurer's strategic and risk objectives.

Beyond the implementing an ERM framework, ICP 16 requires insurers to perform its ORSA in order to assess "the adequacy of its risk management and current, and likely future, solvency position." The ORSA should include the following elements:

- "…Document the rationale, calculations, and action plans arising from this [ORSA] assessment. The ability of an insurer to reflect risks in a robust manner in its own assessment of risk and solvency is supported by an effective overall ERM framework, and by embedding its risk management policy in its operations."
- The insurers board and senior management must be responsible for the ORSA.
- Scaled to an appropriate nature, scale, and complexity of risks for the insurer, the insurer's ORSA must includes all reasonably foreseeable and relevant material risks such as "underwriting, credit, market, operational and liquidity risks and additional risks arising due to membership of a group.

- The assessment is required to identify the relationship between risk management and the level and quality of financial resources needed and available."

In order to provide the maximum benefit to the insurer, the insurer should perform ORSA on a regular basis as to continue to provide relevant information to management and aid in the decision making process.

In order to determine the needed capital, ICP 16 requires insurers to perform the following:

- "determine, as part of its ORSA, the overall financial resources it needs to manage its business given its own risk tolerance and business plans, and to demonstrate that supervisory requirements are met;"
- "base its risk management actions on consideration of its economic capital, regulatory capital requirements and financial resources, including its ORSA;"
- "assess the quality and adequacy of its capital resources to meet regulator."

Considering the insurer's own ERM framework, the insurer should "distinguish between current capital needs and its projected future financial position, having regard for its longer-term business strategy and, in particular, new business plans" as well as consider the regulatory required capital thresholds. Insurers should consider events in which the insurer may suffers losses which will need to be absorbed by its capital and cause a need to raise new capital, or re-capitalize, as adequate capital may not be readily available. For an insurer to raise capital during times of financial stress, it is critical that the insurer maintains market confidence at all times via its "solvency and capital management, investor relationships, robust governance structure/practices and fair market conduct practices."

As previously stated, developing an ERM framework and completing ORSA is not just a one-time event, but requires ongoing maintenance. ICP 16 specifically states the insurers requirement to analyze "its ability to continue in business, and the risk management and financial resources required to do so over a longer time horizon than typically used to determine regulatory capital requirements" as part of ORSA. Furthermore, the insurer is required continual analysis in order "to address a combination of quantitative and qualitative elements in the medium and longer-term business strategy of the insurer and include projections of its future financial position and analysis of its ability to meet future regulatory capital requirements." The insurer is also responsible to demonstrate its ability to manage risk over the long term under reasonable adverse scenarios. The insurer must also address how they will respond to unexpected changes in the market, legal and regulatory arena, and innovations.

Regardless of the selected ERM model, states insurance commissioners, state examiners, and regulators will need to review the insurer's ERM framework. "The insurer's ERM framework and risk management processes (including internal controls) are critical to solvency assessment. Supervisors should therefore assess the adequacy and soundness of the insurer's framework and processes by receiving the appropriate information, including the ORSA regularly." The insurer must note that its operations are the primary responsibility of the board of directions and senior management. In addition, the board of directors and senior management must have the ability to exercise their own business judgment in order to carry out these responsibilities.

ORSA Summary Report

The insurer's ORSA is a component of the insurer's ERM framework and includes a confidential internal assessment of the insurer's material and relevant risks associated with its current business plan and capital resources to support the risk. The insurer's ORSA requirements are as follows:

- Regularly, no less than annually, conduct an ORSA to assess the adequacy of its risk management framework, and current and estimated projected future solvency position;
- Internally document the process and results of the assessment; and
- "Provide a confidential high-level ORSA Summary Report annually to the lead state commissioner if the insurer is a member of an insurance group and, upon request, by the domiciliary state regulator.

The NAIC identified a goal of ORSA as a means to foster an ERM framework at all insurers that are appropriate to the individual insurer.

The ORSA Summary Report includes three sections. Section One, the Description of the Insurer's ERM Framework, requires the insurer to provide evidence of risk culture and governance, risk identification and prioritization, risk appetite tolerances and limits, risk management and control, and risk reporting and communication. In addition, Section One of the ORSA Summary Report should include the following:

- a high-level summary of the insurer's ERM framework principles,
- "describe how the insurer identifies and categorizes relevant and material risks and managers those risks as it executes its business strategy," and
- describe risk monitoring processes and methods, provide risk appetite statements, and explain the relationship between risk tolerances and the amount and quality of risk capital.

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Within this section, the insurer should include its method to monitor and respond to changes in the risk profile as well as the method to include new risk information.

Section Two of the ORSA Summary Report indicates the insurer must provide a "high level summary of the quantitative and/or qualitative assessments of risk exposure in both normal and stressed environments for each material risk category in Section One." This section should also include the following characteristics:

- The assessment should include a "range of outcomes using risk assessment techniques that are appropriate to the nature, scale, and complexity of the risks. Examples of relevant material risk categories may include, but are not limited to, credit, market, liquidity, underwriting, and operational risks."
- "Methods for determining the impact on future financial position may include simple stress tests or more complex stochastic analyses."
- Evaluating risks should occur under both normal and stressed environment.
- "The analysis should be conducted in a matter that is consistent with the way in which the business is managed."
- Any risk tolerance statements should include material quantitative and qualitative risk tolerance limits and how the tolerance statements and limits are determined, taking into account relevant and material categories of risk and the risk relationships that are identified.

Section Three of the ORSA Summary Report should explain how the "insurer combines the qualitative elements of its risk management policy with the quantitative measures of risk exposure in determining the level of financial resources needed to manage its current business and over a longer term business cycle (e.g., the next one to three years)." The intent of this section is to provide the insurance commissions with information to assess the quality of the insurer's risk and capital management.

Conclusion

State Insurance Commissioners from various states, while presenting at the Society of Financial Examiner's conference in July 2013, explained that the RMORSA Model Act will continue to evolve. It is the future of the industry and it will not be deregulated. Insurance companies that have recently or are close to breaching the threshold for mandatory compliance should begin preparing by developing the insurer's ERM framework, performing its ORSA, and drafting its ORSA Summary Report.

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Surveys have revealed that insurance companies are not prepared and do not have a developed ERM framework. Insurers have the option to select an externally developed or develop its own internal ERM framework. The ERM framework should consider underwriting, market, credit, and operational risks that include legal and reputational risk as well as the relationship between risks if specific events occur. Insurers should review its risks and risk relationships under both normal and stressed conditions in order to develop an action plan to raise needed capital in order to remain solvent in the future as part of its ORSA.

Implementing an ERM framework and assessing the insurer's adequacy of its ERM framework as part of ORSA may become a challenge for insurers that may not have the needed expertise or resources to dedicate to become RMORSA Model Act compliance.

In an interview with Steve Johnson, ParenteBeard noted two key takeaways among others as follows.

- Based upon a review of pilot ORSA Summary reports, one report stood out among others according to Mr. Johnson. The only missing element of this report was the risk consideration of executive compensation. Considering that executives continued to receive lavish benefits and compensations after their companies failed during the economic collapse, this risk should be considered and addressed within the company's ERM framework.
- Although RMORSA requires compliance and maybe viewed as an additional compliance exercise, Mr. Johnson has spoken to several insurers to explain how this Model Act is changing the way businesses operate. Mr. Johnson noted those businesses that rise above simply performing compliance exercises and focus on building a strong corporate governance structure, ERM framework, and leverage big data will be successful in the future.

Unfortunately, in some instances it may take a crisis like the economic collapse in the late 2000's to cause the needed change in regulation and internal business culture and priorities. Although the insurance industry fared better than other industries did such as banking and investments with Goldman Sachs, JP Morgan Chase, and Lehman Brothers, the insurance industry must be vigilante in managing its risks and assessing its future capital requirements. If not already started, insurance companies must begin internal conversations as to the needed resource requirements and its plan to become RMORSA Model Act compliant by January 1, 2015.

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The Increasing Importance of Sound Operational Risk Management

By Lou Felice, CFE, NAIC Health and Solvency Policy Advisor and Shanique (Nikki) Hall, NAIC CIPR Manager

Introduction

Recent developments in the financial services industry have underscored the importance of operational risk management (ORM). Operational risk has played a role in many of the banking industry scandals taking place over the past two decades, including Barings Bank, Long-Term Capital Management, Bear Stearns and Lehman Brothers. The recent global financial crisis brought operational risk to the forefront once again. There were a wide range of causes for failures among financial institutions that were linked to the securitization process. Some of these were rooted in poor business practices or strategies. Loose underwriting standards are a prime example. However, other risks were rooted in a failure to initiate or to adhere to proper procedures; exercise proper due diligence; and recognize external deception (e.g., mortgage fraud). These failures are the essence of operational risk.[1]

As the financial system has become more interconnected and complex than ever before, the challenge of understanding and mitigating operational risks has increased. Improvements in ORM have taken on greater focus and visibility within the financial services industry and in many other industries over the past decade. In recent years, the NAIC, through its Solvency Modernization Initiative (SMI), has been exploring ways to increase the regulatory focus on operational risk. In addition, in advance of the Solvency II regulations, many large European insurance companies have begun to establish formal ORM programs. This article provides an overview of operational risk and highlights some of the work financial institutions have taken to effectively measure and manage operational risk.

Operational Risk

The International Association of Insurance Supervisors (IAIS) defines "operational risk" as the risk of adverse change in the value of capital resources resulting from operational events such as inadequacy or failure of internal systems, personnel, procedures or controls, as well as external events.[2] It refers to risk that result from shortfalls or inadequacies in the management of otherwise quantifiable risk, and from unforeseen external events that can impact an insurer. Operational risk potentially exists in all business activities; it encompasses a wide range of events and actions or inactions, such as fraud, human error, accounting errors, legal actions and system failures. Many of these problems arise during the course of conducting day-to-day business operations and are typically managed with little or no incident.

It is important to distinguish the nature of operational risk from that of other types of financial risk such as credit risk (counterparty failure risk, e.g. a credit downgrade or default) or market risk (risk of loss due to an overall decline in the market). Financial institutions normally take on a certain amount of credit and market risk, which they typically try to manage through portfolio diversification of credit instruments and equities. Insurers also take on the risks associated with mispricing policies, misestimating liabilities and mismatching the

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duration of investments vs. policy obligations, which also can be managed through geographical or product diversification, reinsurance and effective hedging strategies. Operational risks, on the other hand, are inherent, as it is a necessary part of conducting business, but have the potential to override management strategies and leave the institution open to "tail risk," thus creating the potential for large losses.

Operational risk became recognized as a major risk class in the mid-1990s following a number of large-scale insolvencies in the banking industry caused or exacerbated by events outside of market and credit risk (i.e., BCCI, 1991; Orange County, 1994; Barings Bank, 1995; and Daiwa Bank, 1995, among others) and undermined the confidence in the banking system. In these cases, significant losses were incurred due to operational risk failures. As a result, many regulators and banking executives recognized financial institutions were exposed to non-credit-related risks, which included operational risk.[3]

In response, the Basel Committee on Banking Supervision (BCBS) released a proposal in June 1999 to replace the 1988 Basel Capital Accord (Basel I), which applied to all banks in the U.S., with a new risk-sensitive capital accord. The initial consultative proposal introduced an operational risk category and corresponding capital requirements. According to BCBS, the change reflected the committee's interest in making the New Basel Capital Accord (Basel II) "more risk sensitive and the realization that risks other than credit and market can be substantial."[4]

The Basel II definition of operational risk is primarily linked to its origin; i.e., events related to trading activities. Pillar 1 in Basel II is focused on only three risk categories in a bank's trading operations: credit risk, operational risk and market risk.[5] A majority of the published literature on operational risk is written on the banking sector and based on the definition of operational risk prescribed by Basel II. However, this definition is inappropriate to adopt in insurance, as the insurance business model is much different from that of banking. Hence, the characteristics and sources of operational risk are different in these two sectors. Banks are in the borrowing and lending business, while insurers act as risk-takers and managers of insurable risks. Banking/investment banking is a transactional business, supported by short-term funding in the capital markets, whereas insurers' business is not transactional. Insurers cover risk exposures through reinsurance.[6]

Consequently, it has been argued operational failures in the insurance sector are much less likely to create systemic risk in the economy. However, for some large life insurers, the line between banking activities and insurance activities has been blurred. Furthermore, the existence of insurance-based large financial conglomerates has drawn the attention of national and international regulatory bodies. Examples are the systemically important financial institution (SIFI) designation process in the United States and the global Financial

Stability Board/IAIS effort to identify and designate globally systemically important insurers (G-SIIs). The former includes insurance-led institutions within its scope, and the latter is focused on such groups.

Identifying/Quantifying Operational Risk

Historically, organizations have accepted operational risk as an unavoidable cost of doing business. However, given operational risk has become recognized as a distinct risk category, the value of effectively managing operational risk has increased considerably of late. While there is currently a huge demand for operational risk quantification, the actual management of operational risk has not evolved commensurately. This is because operational risk is difficult to identify and assess as the causes are extremely heterogeneous, thus making developing statistical models for operational risk challenging. There are many different types of operational risk and the extent of operational risk can vary based on qualitative factors including corporate governance and the quality of internal controls in place. The Financial Times recently noted operational risk is the most amorphous and the hardest to protect against.[7]

A sound operational risk model extends well beyond the confines of a formula-based quantification. It encompasses a company's business activities and is an integral part of an efficient enterprise risk-management framework. An insurer's underlying operational risk profile should be thoroughly reviewed across its range of business activities in order to identify and estimate the model input requirements. The principal challenge is to combine two essential sources of information: empirical loss data and expert judgment.

Many companies have been leveraging the experience of the banking industry, which has been focused on operational risk for more than a decade. The BCBS framework includes seven distinct types of operational risks varying in terms of frequency and severity.[8] For example, internal fraud is a risk considered low frequency, high severity. Frequency and severity are vital in estimating potential operational risk losses. However, historical data on the frequency and severity of losses are often not available. Thus, uniform historical data upon which operational risk capital charges could be built is lacking. Most financial institutions are still in the process of collecting data.

Organizations, such as the Operational Risk Consortium (ORIC), have begun to collect data from participating financial institutions to develop operational risk loss data consortiums. The ORIC database includes loss data provided by 225 large companies, including data from 16 core insurer members of the Association of British Insurers (ABI) and is focused on European operations. The database offers benchmarks against peers for loss experience comparison purposes and comparison of overall risk-management practices. The anonymized information is divided into eight categories with four severity levels and includes the frequency and amounts of loss events.

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Although there are potential drawbacks to using self-reported data, it could be beneficial in identifying trends. The information is used to generate management reports that assist companies in prioritizing resources to identify and address control weaknesses in specific areas. Although the ability to integrate the data into models for purposes of a precise capital calculation is not there yet, use of scenario analysis could improve an entities ability to avoid significant losses from operational risk failures.

Operational Risk In Insurance And Capital Requirements

An operational risk event can cause severe losses and may lead to an insurer's insolvency or near insolvency. Traditional risk mitigation approaches (e.g., internal controls, auditing) are not expressly designed for low frequency, high severity events.[9] They are designed around capturing transactional errors, which tend to be of a manageable loss size, whereas operational risk in insurance entities originates mainly in other areas. It is, therefore, important to have an explicit operational risk buffer in the regulatory capital test to provide a buffer for costly operational risk events. This is being recognized by regulatory authorities around the globe, and has captured the attention of the insurance industry, as well. As noted above, databases (such as ORIC and others) are being developed and expanded to include volunteer data donors from the insurance industry.

State insurance regulators, working together through the NAIC, have been looking at whether and how best to incorporate internal and external aspects of operational risk more explicitly into the risk-based capital (RBC) formulas. In 2013, the Capital Adequacy (E) Task Force turned its attention to operational risk. The Task Force's Solvency Modernization RBC (E) Subgroup, Chaired by Alan Seeley of New Mexico's Office of the Superintendent of Insurance, has been charged as follows: "Evaluate options for developing an operational risk charge in each of the RBC formulas and provide a recommendation to the Capital Adequacy (E) Task Force as to treatment of operational risk in the RBC formulas."

The Subgroup began by looking at how other jurisdictions incorporate operational risk into their regulatory capital formulas, and received presentations from the Bermuda Monetary Authority and the Office of the Superintendent of Financial Institutions Canada (OSFI). A third presentation from the European Union (EU) covered the proposed regulatory approach in Solvency II, which is not yet in effect. The Subgroup's short-term goals include: identifying appropriate risk exposure proxies; developing a simple factor-based capital requirement within the RBC formulas as early as 2014; and starting a process for identifying how and where the current RBC formulas could address operational risk. In the long run (three to five years to implementation), the Subgroup plans to follow and provide input into further development and use of an operational risk database and other potential qualitative aspects that could lead to a more risk-sensitive RBC approach.

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Recent NAIC initiatives have also resulted in the adoption of the *Risk Management and Own Risk and Solvency Assessment Model Act* (#505), as well as corporate governance standards as qualitative means for considering internal operational risk and some aspects of external risk via a group-wide assessment. An Own Risk and Solvency Assessment (ORSA) will require insurers to analyze all reasonably foreseeable and relevant material risks (i.e., underwriting, credit, market, operational, liquidity risks, etc.) that could have an impact on an insurer's ability to meet its policyholder obligations. Resulting from the NAIC's SMI, large- and medium-size U.S. insurance groups and/or insurers will be required to regularly conduct an ORSA starting in 2015.

Internationally, methods to quantify and model operational risks have mostly been captured using formulaic approaches (i.e., a factor applied to a base number line annual premiums revenue or defined assets or liabilities). Canadian capital requirements for operational risk are formulaic, applying factors to risk exposure proxies with a focus on retention of operational risk regardless of mitigation strategies for other types of risks (e.g., reinsurance). Bermuda's regulatory capital formula includes a capital add-on that includes a qualitative adjustment based on responses to a corporate governance questionnaire and possibly other inspection or analysis findings.

Solvency II requirements add the element of internal operational risk models to calculating regulatory capital requirements. Solvency II includes a standard formula approach to operational risk that applies different factors to pre-established risk exposure proxies for life vs. non-life insurers. In addition, there is an option to use an internal model approach under Solvency II to establish a regulatory capital requirement for operational risk for insurance and reinsurance companies. The inputs to the models can vary based on the specificities of the institution's business activities, which can make comparisons across companies difficult. However the models are reviewed by regulators for statistical integrity and conformity with internal capital models (the so-called "use test").

Eu-U.s. Insurance Regulatory Dialogue Project

In 2012, the EU and the U.S. completed a comparison of the U.S. insurance regulatory system with that of the three-pillar approach of the proposed Solvency II Directive in Europe. This project, which looked at seven elements of regulation, is referred to as the EU-U.S. Insurance Regulatory Dialogue Project (EU-U.S. Dialogue) and is described in a final report issued in December 2012. One of the elements covered solvency and capital requirements.

At the end of the EU-U.S. Dialogue, a number of future work streams were agreed upon to explore opportunities to further harmonize the two systems. For capital and solvency, it was agreed, along with two other risk categories,

to look at operational risk. Solvency II incorporates a provision for operational risk, and is in the development stages for U.S. RBC. The two sides will interact as follows:

- The EU will share information on the methodology and data used for calibrating operational risk in Solvency II. This includes the recent delivery of a presentation to NAIC staff currently responsible for the development of operational risk in the U.S.
- The U.S. will share information on the methodology and data used for calibrating operational risk in RBC. This could include the U.S. cooperating with EU counterparts during the ongoing work toward the definition of a factor-based approach to operational risk to incorporate in the RBC.

This initial phase is tentatively scheduled to run between now and June 30, 2014. In the longer-term, the parties might work together to develop/enhance an operational risk database. The EU has not embraced the ORIC database as yet, and the U.S. is interested in use of a database for its longer-term work on operational risk. This provides an area for further discussion and possible cooperation between U.S. and EU regulators.

Summary

Operational risk is now recognized as a major risk class across all financial institutions. In the increasingly complex and interconnected global environment, the value of effectively measuring and managing operational risk has increased significantly. State insurance regulators and the NAIC continue to discuss operational risks, its possible inclusion into the RBC formulas, as well as its role in insolvencies and its interaction with other risk categories.

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The Increasing Importance of Sound Operational Risk Management

(continued)

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