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Bulletin: Federally-Regulated Insurers in Canada to Complete an Own Risk and Solvency Assessment

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Before insurers in Canada prepare to close their books on 2013, they should consider the final version of *Guideline E-19: Own Risk and Solvency Assessment* (the "**ORSA Guideline**") recently released by the Canadian Office of the Superintendent of Financial Institutions ("**OSFI**"). The ORSA Guideline has an implementation date of January 1, 2014 and will require action in the first quarter of 2014. The new Guideline introduces the internationally recognized concept of ORSAs to federally regulated insurers in Canada (including branches of foreign companies) and reflects international best practices.

This bulletin will provide an overview as to what an ORSA is, how it is used, the timelines OSFI has set with respect to implementing ORSAs, the regulatory objectives behind the adoption of the ORSA standard, and recommendations of how insurers should proceed.

What is an ORSA?

OSFI has envisioned ORSA as a self-regulated tool to assist in the management and analysis of an insurer's own capital requirements. ORSAs function in tandem with the current Dynamic Capital Adequacy Testing regime and capital management targets, integrating these measures with an insurer's broader risk management strategy.

ORSAs are prepared and overseen by an insurer's board of directors (or the chief agent in Canada of a foreign company), with senior management often delegated certain performance tasks. The assessment itself should be performed regularly, with the results documented in a formal report to the board of directors or chief agent on at least an annual basis. As ORSAs are implemented and executed by the insurer, the process should be continuously reviewed for integrity, accuracy and reasonableness.

ORSA has been described by OSFI as a forward-looking and dynamic self-assessment process intended to enhance the understanding between capital requirements and risk tolerance. There is no standard form implementation to ORSA, as insurers have different risk appetites and institutional complexities, but the ORSA Guideline lists the following five key elements that all ORSAs must include:

1. Comprehensive identification and assessment of risks
2. Relating risk to capital
3. Board oversight and senior management responsibility
4. Monitoring and reporting
5. Internal controls and objective review

A robust internal review mechanism will strengthen the value insurers get out of their ORSAs. Insurers are most aware of their capital needs, and setting internal targets to manage capital levels accordingly will introduce a valuable new dimension to maintaining healthy ratios. Where insurers have broad discretion to set the inputs with which their ORSA model will operate, OSFI has insisted that ORSAs should be calibrated to determine the total amount of capital needed to withstand the most severe loss. As a result, the risk identification process should be as inclusive as possible, in order to accommodate all known, reasonably foreseeable, emerging and other relevant risks that may affect an insurer's ability to continue to operate, in particular in a stress situation such as a catastrophic

event. The ORSA should not just be limited to insurance risk, but should include business risks, such as hedging risks, reinsurance risks, and investment risks.

How is an ORSA used?

The purpose of an ORSA is to connect an insurer's business and risks to its capital and solvency. Accordingly, an insurer's determination of both its capital needs and internal target capital levels and ratios will be a key aspect of its ORSA process. For each risk, an insurer should be able to determine whether an explicit quantity of capital should be held, and how to best aggregate the results for each risk.

Insurers' self-assessments should reflect their own choice of inputs, including data sets, time horizons, financial tools, and methodologies. Insurers are also expected to consider academic and professional literature dealing with quantifying risks, as well as risk mitigation. However, the tools and approaches should allow the insurer to determine the total amount of capital required to cover severe losses, as ultimately, ORSAs will assist an insurer in setting customized internal capital targets that will allow it to cover the biggest catastrophes.

Once an insurer has determined its capital needs through its ORSA, it should establish internal capital targets, following the process and standards set out in OSFI Guideline A-4, *Regulatory Capital and Internal Capital Targets*. In determining these targets, insurers must continue to consider the impact of various adverse scenarios of varying nature and severity, including combinations of adverse scenarios, and the ability of the insurer to continue as a going concern and to avoid interventions by OSFI. Internal capital targets through the ORSA should be calculated bearing in mind stress tests conducted on the insurer, including its DCAT scenarios.

Finally, senior management and the board of directors (or the chief agent) of insurers should receive regular and timely reports on the insurer's risks and capital. These reports should allow recipients to:

- Evaluate the level and trend of material risks and their potential effect on capital;
- Evaluate the sensitivity and reasonableness of assumptions used in the risk and capital assessment and measurement process;
- Determine that the insurer holds sufficient capital in relation to established capital adequacy targets and goals (both internal and regulatory/external);
- Evaluate the adequacy of capital using stresses and scenarios; and
- Assess future capital needs (including dividend plans and issuance/retirement of capital instruments) and make any adjustments to the insurer's strategic, capital and other plans, as necessary.

The monitoring, assessment and reporting process should accommodate current and forecast business environments, and should be adjusted when appropriate to ensure that capital levels remain adequate during periods when the insurer is under stress and through entire business cycles.

What is next?

Insurers and insurance groups should prepare for the ORSA requirement to take effect, as the ORSA Guideline has an effective date of January 1, 2014. Still, OSFI has stated that an industry-wide implementation will not occur until later in the calendar year.

OSFI expects insurers to make initial ORSA reports available at some point in 2014, and has requested that insurers respond to them with the effective date of their initial ORSA report by March 31, 2014. OSFI does not need to approve an ORSA, but has the right to review an insurer's ORSA filings. The ORSA reports made to the board of directors or chief agent may also be reviewed by OSFI, in order to determine whether the ORSA is consistent with OSFI's understanding of the insurer's business practices, including risk tolerance and risk profile. The quality and frequency of OSFI's review of an insurer's ORSA will reflect the scope, complexity, and nature of the activities it insures, measured against OSFI's own supervisory framework.

Insurance groups in Canada are permitted to prepare a group ORSA, provided that where an insurer's business and risk profiles or circumstances are not adequately reflected in a group ORSA, OSFI expects that insurer to prepare a unique ORSA including only the consolidated Canadian operations of the insurer.

Best Practices

Insurers in Canada are advised to:

- Prepare for the ORSA Guideline to become effective, including meeting with ORSA transition teams as required;
- Consult with their OSFI relationship managers to discuss any methodological or procedural questions;
- Review with other members of their corporate group the approach that the group will be taking to implement the ORSA Guideline, including any implementation lessons learned in other jurisdictions;
- Prepare training programs for boards of directors and senior management, to ensure that they understand both the ORSA process as well as how ORSA will fit within the insurer's strategic practices; and
- Consider what risk and capital information they will want in order to develop their ORSA, in order to ensure that the best quality and types of information are provided in 2013 year-end financials, as well as comparisons against previous years.

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