

Solvency 2 – Own Risk and Solvency Assessment (ORSA)

Enterprise Risk Management for Actuaries
GCAE/Hellenic Actuarial Society Summer
School

Samos – July 2010

Solvency II – Three Pillar Approach



Governance

Pillar 1:

Quantitative capital requirements

- Market-consistent valuation
- Own funds
- Economic risk based capital requirements
 - minimum (MCR)
 - solvency (SCR)
- Groups

Pillar 2:

Qualitative supervisory review

- Internal controls and risk management
- Required functions
- Own risk and solvency assessment (ORSA)
- Supervisory review
- Capital add-ons

Pillar 3:

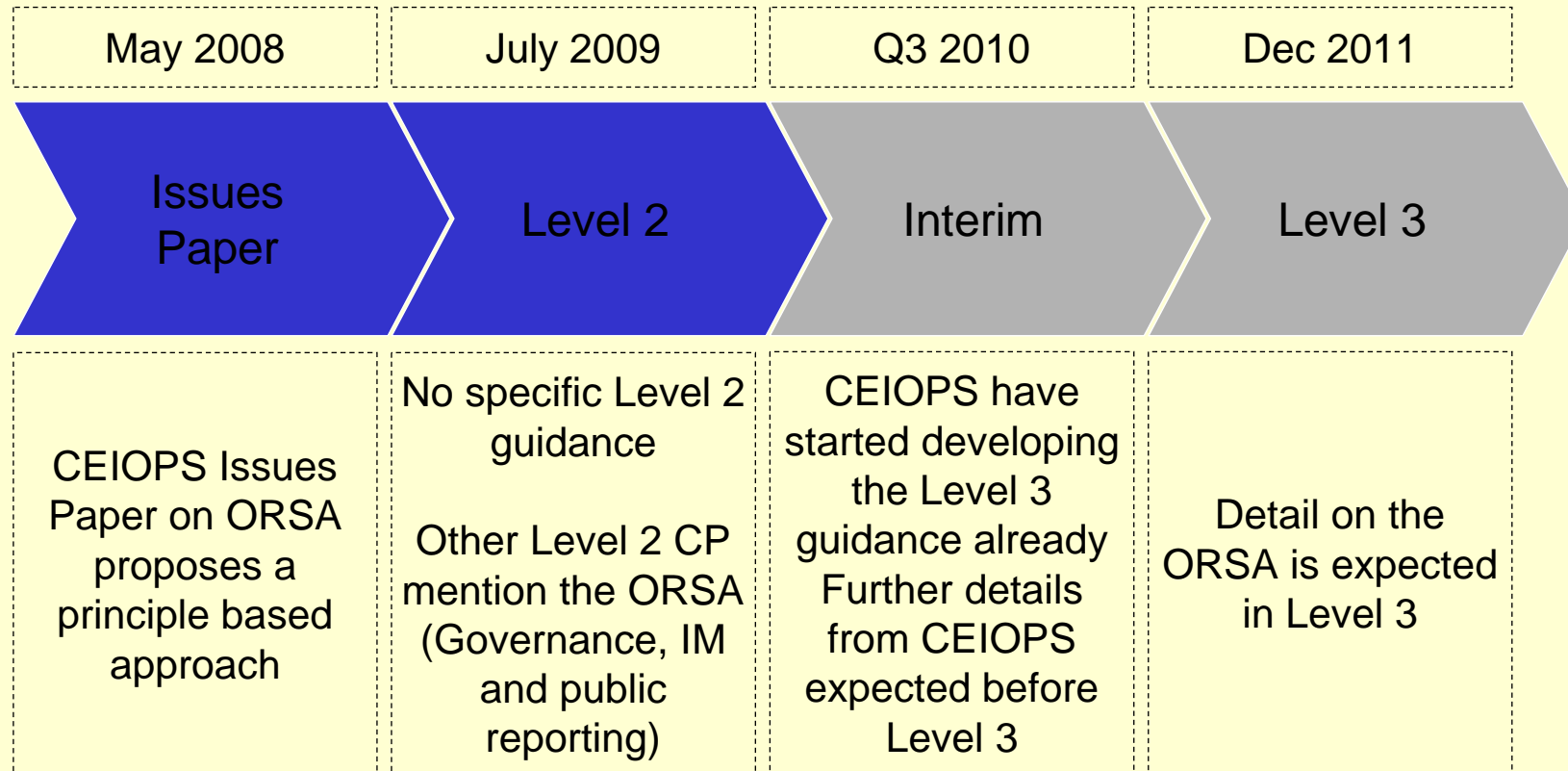
Market discipline

- Transparency
- Disclosure
- Solvency and financial condition report (SFCR)
 - solo
 - group

Compliance and Audit

CEIOPS Progress

ORSA guidance timeline



- Not a well developed area of Solvency II
- CEIOPS recognises that this is an area causing concern among stakeholders

ORSA Requirements

Definition of ORSA



- CEIOPS Issues paper 27 May 2008 defines the ORSA

9. The entirety of the processes and procedures employed to identify, assess, monitor, manage, and report the short and long term risks a (re)insurance undertaking faces or may face and to determine the own funds necessary to ensure that the undertaking's overall solvency needs are met at all times

- What is the ORSA?
 - Risk management tool
 - For assessing risks and own funds required to back them
 - ‘ORSA process’ versus ‘ORSA outcome’
 - More than a just a calculation engine!
- Proportionality principle

ORSA Requirements

Uses and limitations



- The Explanatory Memorandum to the Financial Directive Proposal set out the uses for the ORSA

- It is an internal assessment process within the undertaking and is as such embedded in the strategic decisions of the undertaking. It is also a supervisory tool for the supervisory authorities, which must be informed about the results of the own risk and solvency assessment of the undertaking

- It further sets out what the ORSA is not:

The ORSA:

- a) does not require an undertaking to develop an internal model;
- b) is not a capital requirement different from the SCR and the MCR;
- c) should not be too burdensome.

CEIOPS guidance

ORSA principles



Principle A

The ORSA is the responsibility of the undertaking and should be regularly reviewed and approved by the undertaking's administrative or management body.

Principle B

The ORSA should encompass all material risks that may have an impact on the undertaking's ability to meet its obligations under insurance contracts

Principle C

The ORSA should be based on adequate measurement and assessment processes and form an integral part of the management process and decision making framework of the undertaking

Principle D

The ORSA should be forward-looking, taking into account the undertaking's business plans and projections

Principle E

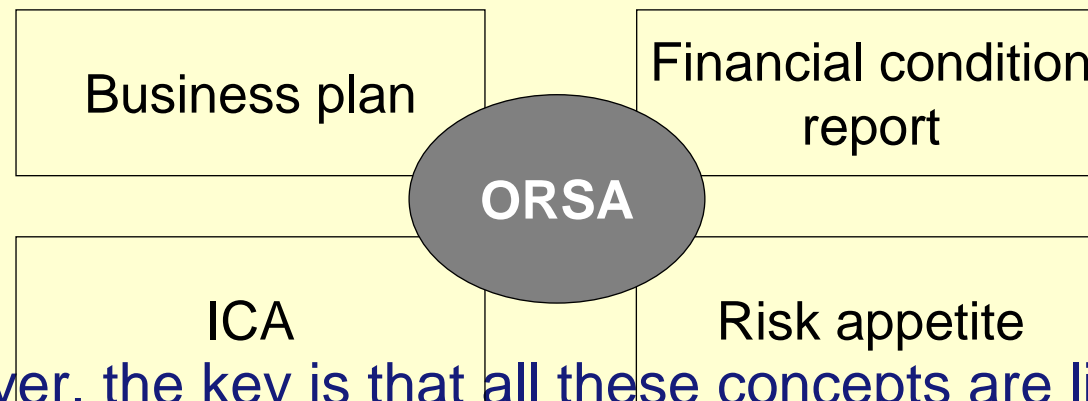
The ORSA process and outcome should be appropriately evidenced and internally documented as well as independently assessed

ORSA Requirements

Comparing existing processes



- It will link a number of the existing processes and reports that life companies produce already:



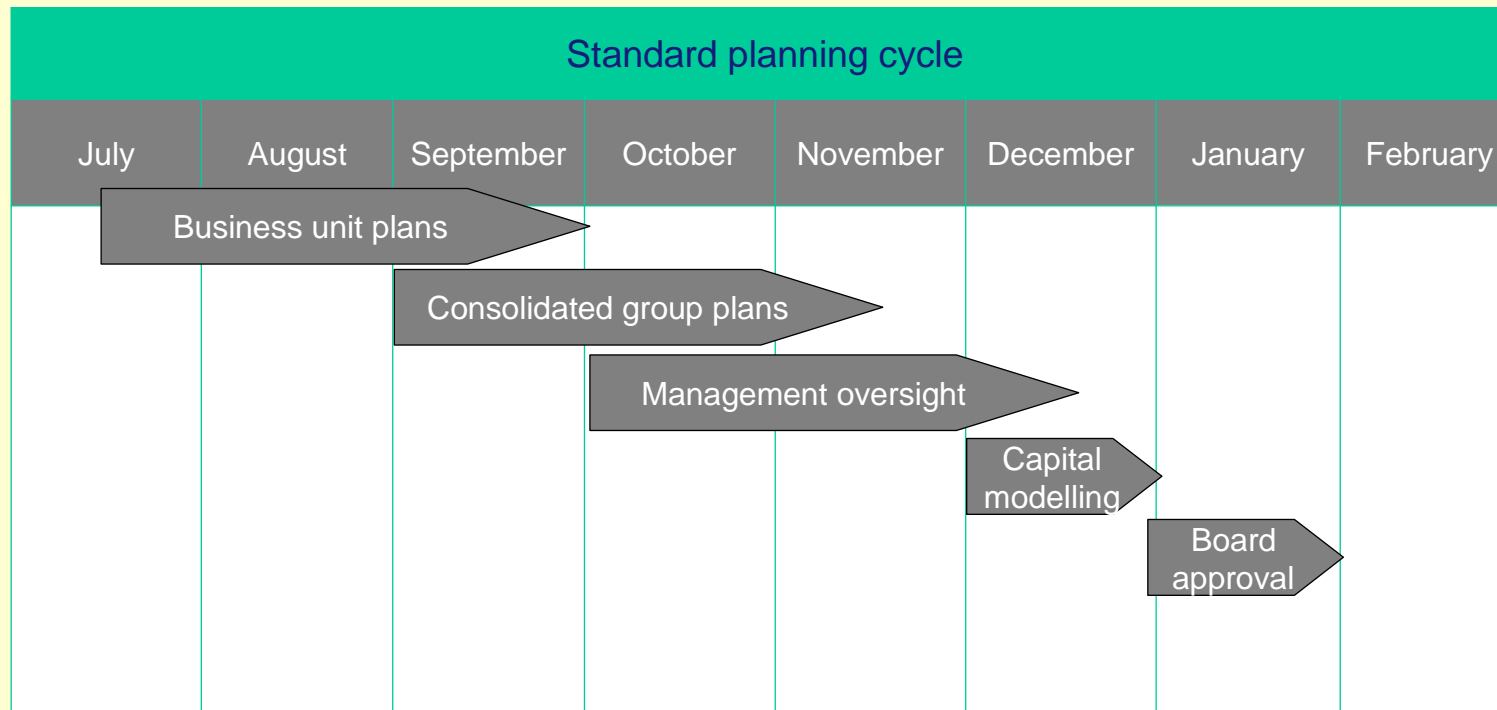
- However, the key is that all these concepts are linked into one report. Therefore, the ORSA should include:
 - Forward looking (linked to the company's business plan)
 - Own risk assessment (linked to the company's risk appetite and ICA)
 - Solvency projection (replaces the financial condition report)

ORSA Requirements

Comparing existing processes



- Integrating ORSA into business planning
 - Advanced companies will have an ICA projection incorporated into their business planning cycle.
 - This is often at the end of the process as a check that the plan can be supported with existing capital.

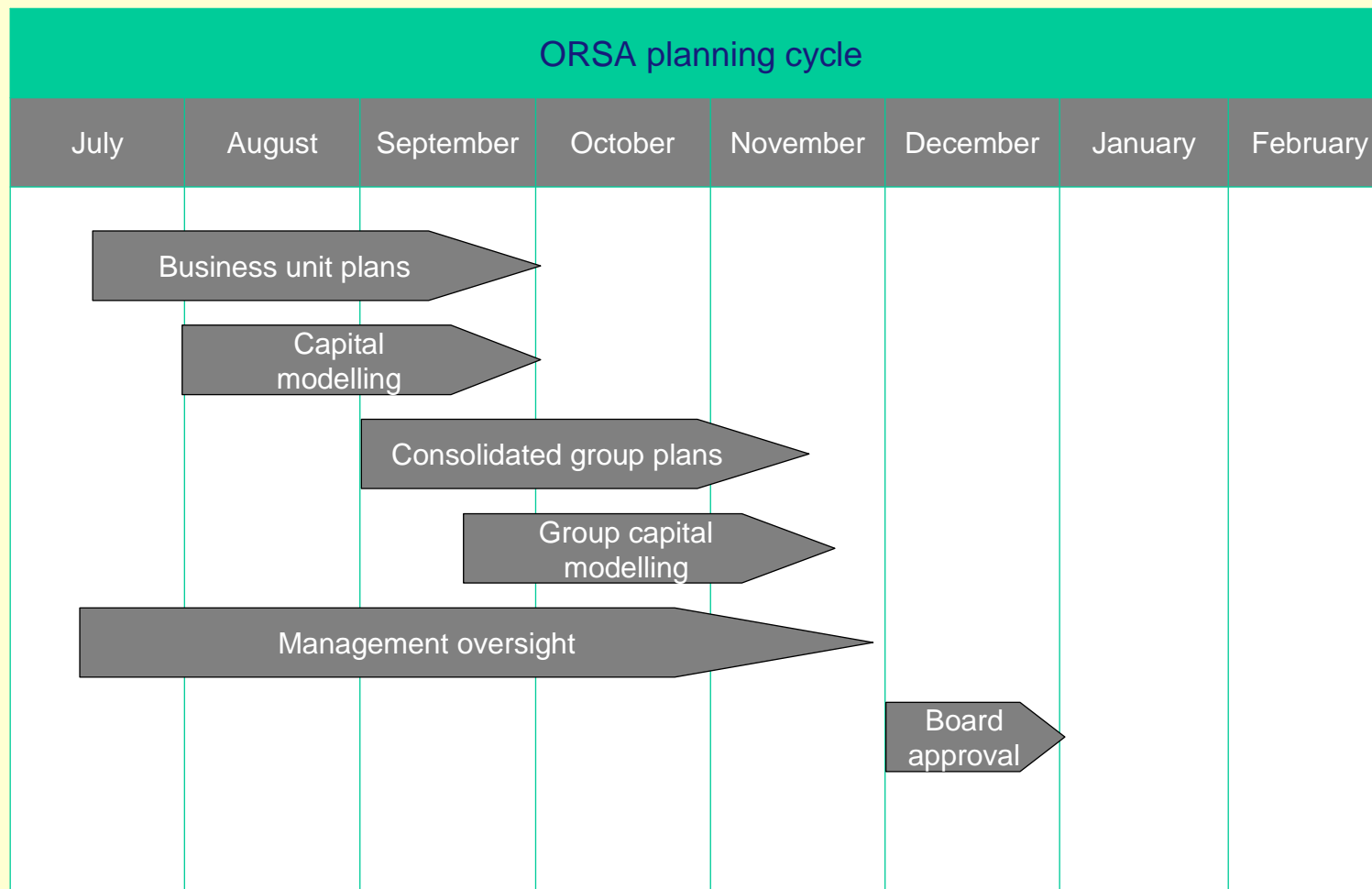


ORSA Requirements

Comparing existing processes



- ORSA means that capital modelling and management oversight should be integrated into the planning cycle at a much earlier



ORSA versus Pillar 1 Comparison



	Pillar 1 SCR (Standard formula, partial or full internal model)	ORSA
Risk time horizon	One year time horizon	Business planning time horizon
Risks covered	Underwriting, Market, Counterparty and Operational risk	Pillar 1 risks plus for example Liquidity, Reputational, Strategic, Pension and Model Error risk
Confidence level	99.5% confidence level	Potentially different confidence level for business or rating purposes
Management actions	Can include approved management actions	Can consider any internally agreed management actions that may influence risk profile
Calculation Frequency	Potentially quarterly	Regularly/probably at least as frequently as Pillar 1 model
Documentation	Extensive documentation required	Requirements are still unclear but likely to be similar to that required under Pillar 1

ORSA Disclosure Requirements



- Consultation Paper 58 gives detail on ORSA disclosure requirements...
- ORSA process will need to be publicly disclosed, including details on:
 - Integration into management process
 - Determination of solvency needs
 - Evidence and review process
- ORSA result does not need to be publicly disclosed
- Supervisory reporting
 - ORSA information will be reported to supervisory authorities as part of SRP

ORSA Disclosure

Interaction between pillars



Pillar 1: Quantative Requirements
Technical provisions, MCR and SCR (standard formula/internal model), Own funds, etc

Pillar 2: System Of Governance
Compliance with system of governance including risk management (including the ORSA)
Fit and proper requirements, outsourcing, internal controls, internal audit etc

Pillar 3: Report To Supervisor (RTS) and Solvency and Financial Condition Report (SFCR)
RTS: Private quantative and narrative information submitted to supervisor
SFCR: Public information required to be disclosed to market

Supervisory Review Process (SRP)

The supervisory review of quantative requirements, the system of governance as reported in the RTS and SFCR

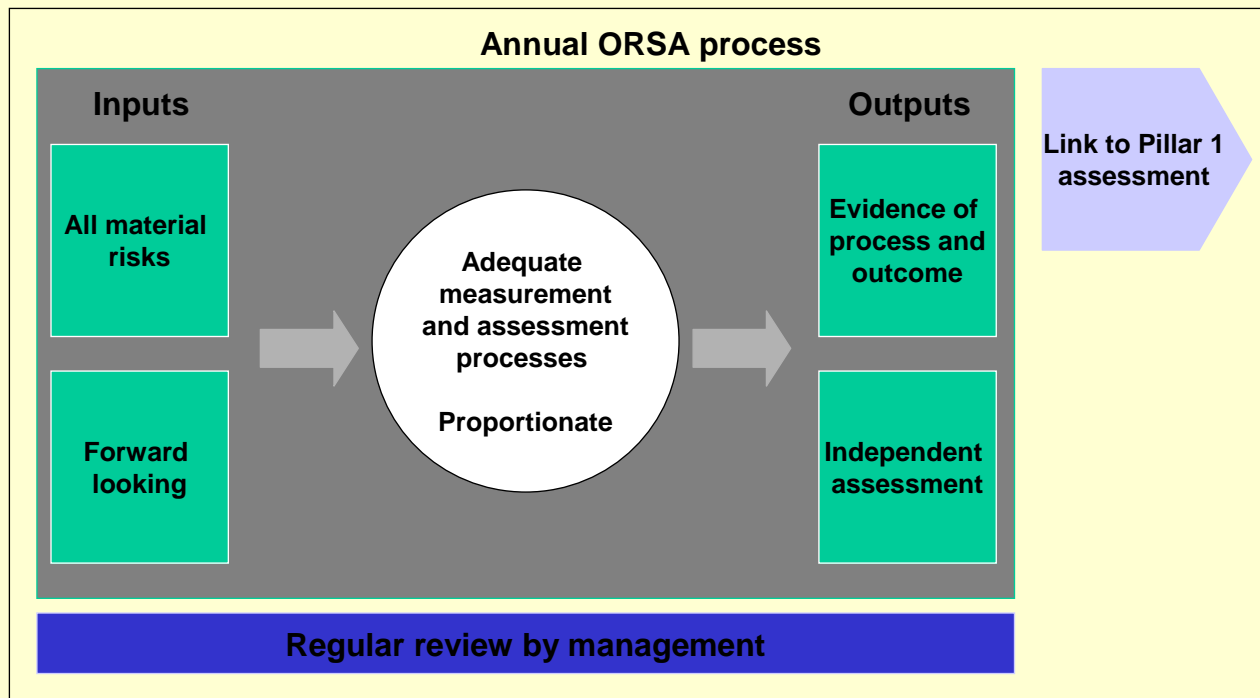
The ORSA will form part of the RTS

Still some questions...



- What is expected from undertakings?
- What is to be submitted to supervisors?
- What will supervisors expect of the ORSA process?
- What is interaction between internal model and capital additions?
- How will principle of proportionality be applied?
- Group ORSA?

ORSA Process



Article 45



▪ **Own risk and solvency assessment**

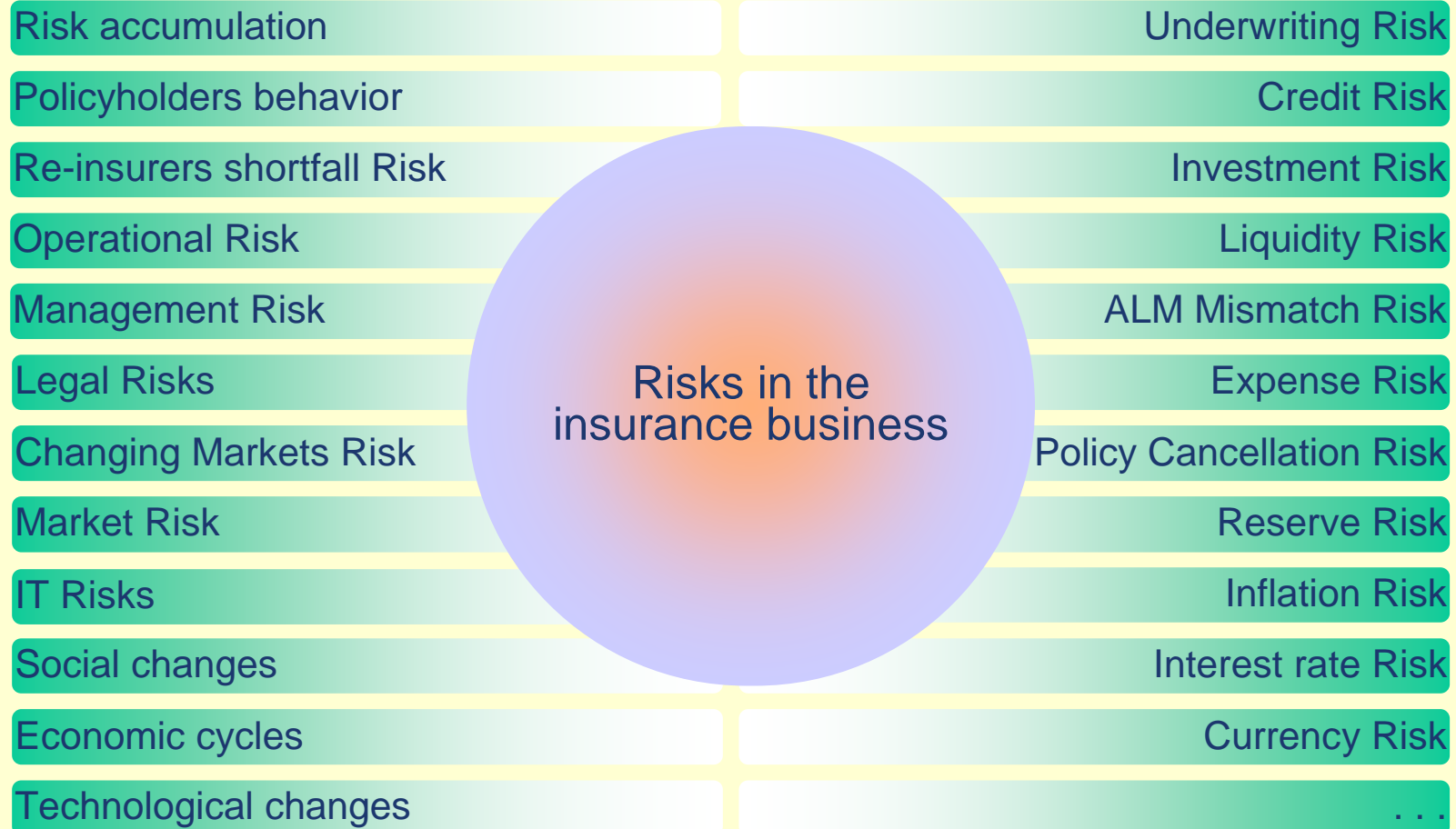
- 1. As part of its risk-management system every insurance undertaking and reinsurance undertaking shall conduct its own risk and solvency assessment.
- That assessment shall include at least the following:
 - (a) the overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the undertaking;
 - (b) the compliance, on a continuous basis, with the capital requirements, as laid down in Chapter VI, Sections 4 and 5 and with the requirements regarding technical provisions, as laid down in Chapter VI, Section 2;
 - (c) the significance with which the risk profile of the undertaking concerned deviates from the assumptions underlying the Solvency Capital Requirement as laid down in Article 101(3), calculated with the standard formula in accordance with Chapter VI, Section 4, Subsection 2 or with its partial or full internal model in accordance with Chapter VI, Section 4, Subsection 3.
- 2. For the purposes of paragraph 1(a), the undertaking concerned shall have in place processes which are proportionate to the nature, scale and complexity of the risks inherent in its business and which enable it to properly identify and assess the risks it faces in the short and long term and to which it is or could be exposed. The undertaking shall demonstrate the methods used in that assessment.
- 3. In the case referred to in paragraph 1(c), when an internal model is used, the assessment shall be performed together with the recalibration that transforms the internal risk numbers into the Solvency Capital Requirement risk measure and calibration.
- 4. The own-risk and solvency assessment shall be an integral part of the business strategy and shall be taken into account on an ongoing basis in the strategic decisions of the undertaking.
- 5. Insurance and reinsurance undertakings shall perform the assessment referred to in paragraph 1 regularly and without any delay following any significant change in their risk profile.
- 6. The insurance and reinsurance undertakings shall inform the supervisory authorities of the results of each own-risk and solvency assessment as part of the information reported under Article 35.
- 7. The own-risk and solvency assessment shall not serve to calculate a capital requirement. The Solvency Capital Requirement shall be adjusted only in accordance with Articles 37, 231 to 233 and 238.

Due diligence on your own business



- Commentary on sources of business and potential implications for level, trend and volatility of future experience;
- Commentary of the size of the portfolio and homogeneous risk groups within the portfolio and the similar implications;
- Description of the history of the evolution of the portfolio with assessment of implications;
- Distribution by case size within the portfolio with commentary on average and dispersion;
- Description of relevant contract terms – general, special features, potentially onerous insurability options, renewal guarantees, etc;
- Commentary on reserve risks, particularly on
 - discounting effects
 - run-off patterns for long-tail business
- Commentary on company's asset allocation and potentially hedging of insurance liabilities, particularly
 - hedging of interest rate risks
- Commentary on claims policy/processes and any implications;
- Commentary on reinsurance policy and implications;
- Commentary on underwriting policy/processes and implications;
- Consideration of possible risk concentrations – geographic / occupational and any consequent catastrophic exposures;
- Past experience and any variations or trends in that experience with reasons / implications;
- Any other special features

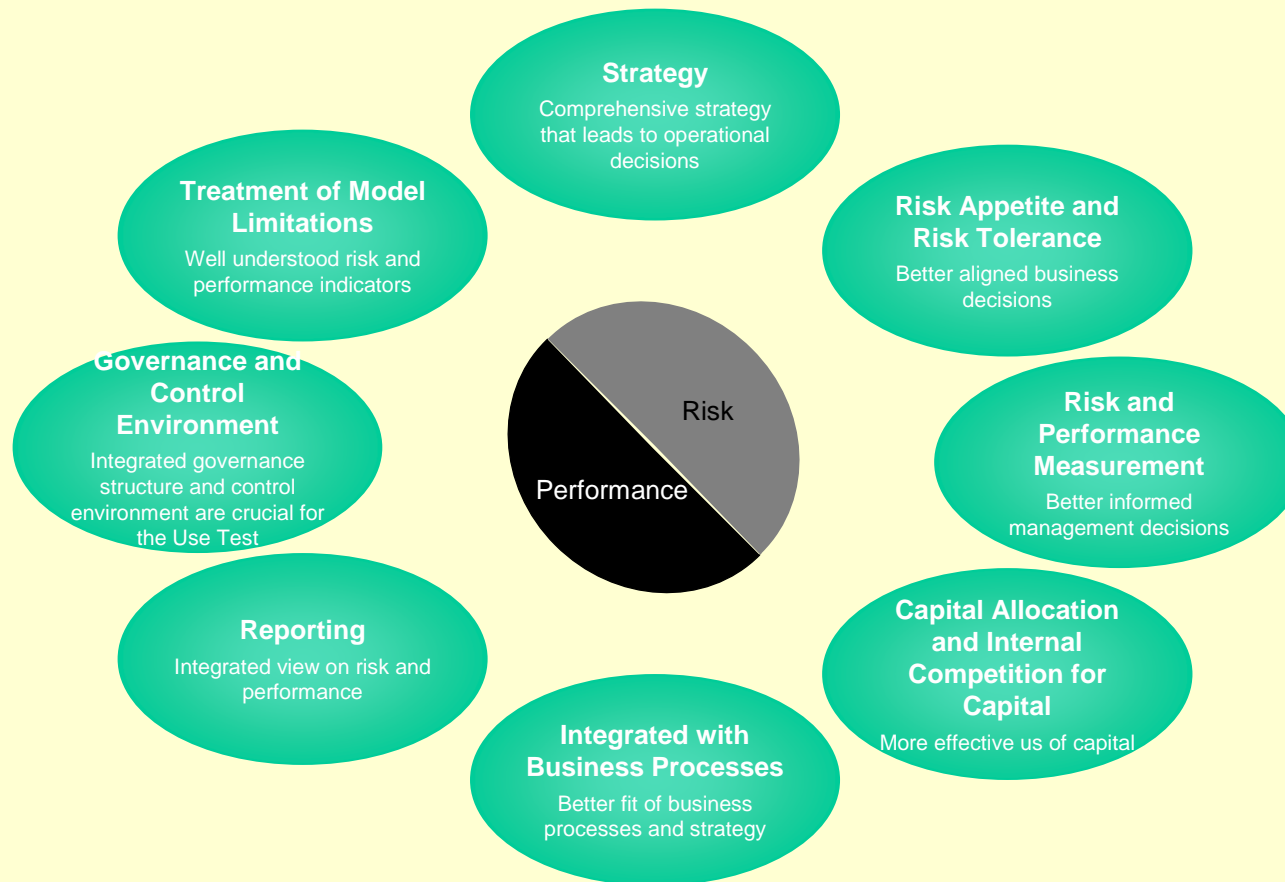
Risks in insurance business



ORSA Building Blocks

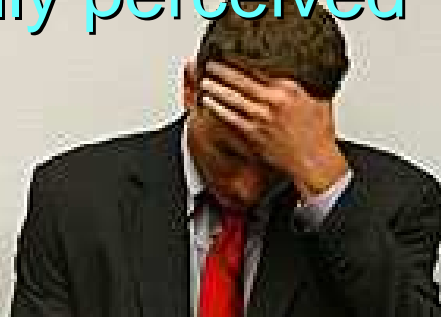
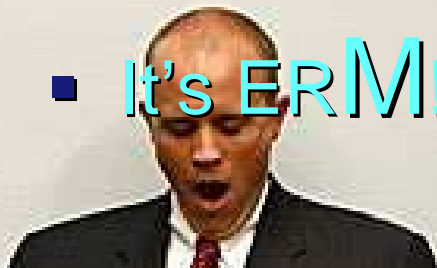


The Eight Dimensions of Risk and Performance Management



Some personal thoughts

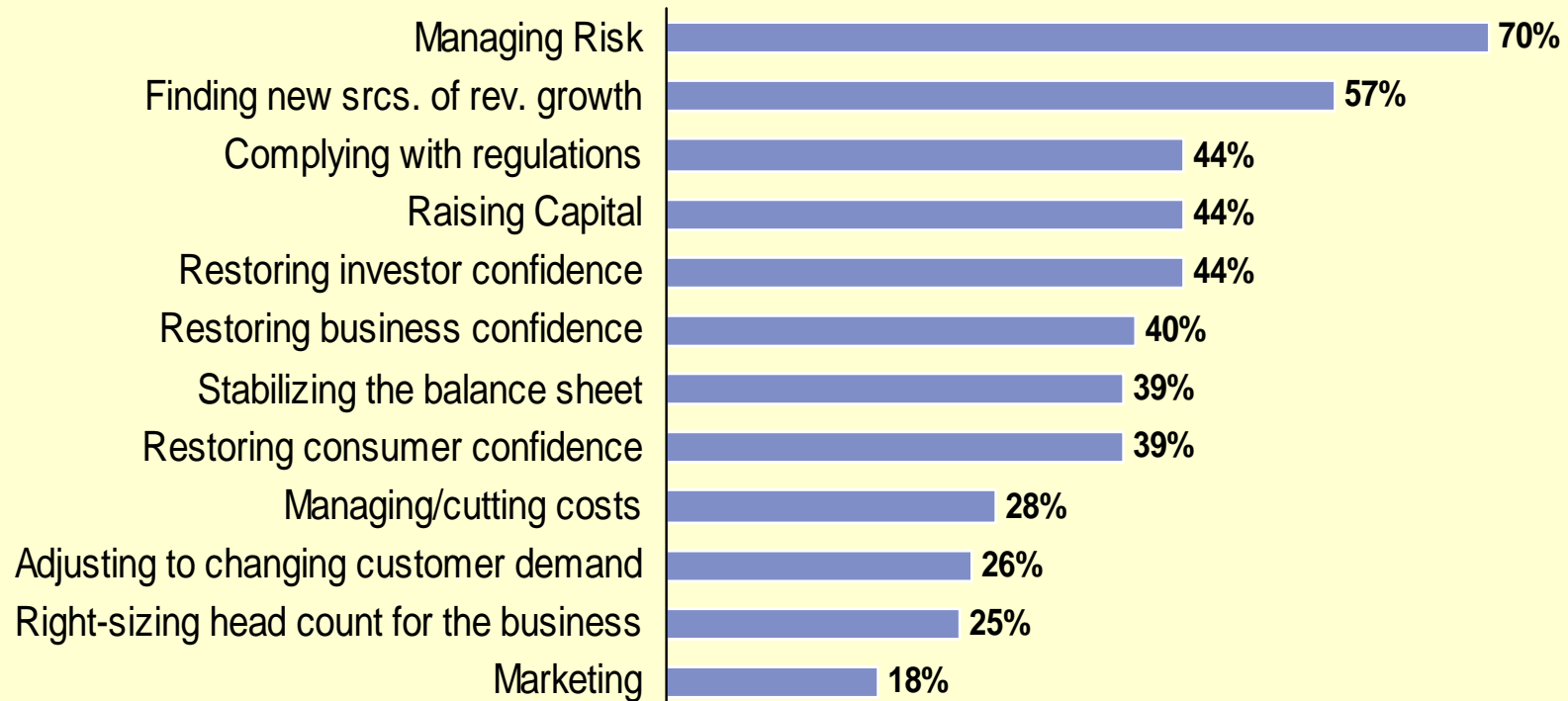
- Risk management is a team sport
- Active exchange of top-down and bottom-up risk views is essential
- The appropriate mix of (bottom-up) skills and experiences often depends on the context
- Directors (top-down) should address substance as well as process
- Things are never really as good or as bad as they are generally perceived
- It's ERM!



Biggest Challenges Currently Face



FS / Banking Executives



**Both technology (66%) and consumer (55%) said
“Finding New Sources of Revenue Growth”**

Keys to ORSA



- Ownership by the governing body
- Forward looking

ORSA – Risk navigation



- Emerging hazards
- Financial market risks
- Macroeconomic risks
- Competitive risks

- Key questions:
 - How is the future going to be different?
 - What combination of circumstances, however implausible, could harm us?
 - What can go wrong?



Internal model and ORSA



- “In our view, if the undertaking is using an approved Internal Model, it must necessarily be used to perform the ORSA. Consistency between what the undertaking considers right for the ORSA and the Internal Model assumptions is a must if the undertaking is to pass the use test.”
- Dynamic tool vs ‘production’ model
- How to demonstrate consistency?

Proportionality and ORSA



- “With regard to proportionality we wonder whether you could give some examples of specific elements of the ORSA where in your opinion the proportionality principle could apply.”

- 41. 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. Regardless of the nature, scale or complexity of its business and irrespective of the approach used by an insurer to manage risk and capital, every insurer should undertake its own risk and solvency assessment (ORSA) and document the rationale, calculations and action plans arising from this assessment. It is recognised that the nature of the assessment undertaken by a particular insurer should be appropriate to the nature, scale and complexity of its risks.

- 42. In its ORSA an insurer should consider all material risks that may have an impact on its ability to meet its obligations to policyholders, including in that assessment a consideration of the impact of future changes in economic conditions or other external factors. An insurer should undertake an ORSA on a regular basis so that it continues to provide relevant information for its management and decision making processes. The insurer should regularly reassess the causes of risk, and the extent to which particular risks are material. Significant changes in the risk profile of the insurer should prompt it to undertake a new ORSA. Risk assessment should be done in conjunction with consideration of the effectiveness of applicable controls to mitigate the risks.

- 43. While the prime purpose of the ORSA is to provide the board and senior management with an assessment of whether its risk management and solvency position is currently adequate and is likely to remain so in future, the output of an insurer's ORSA may also serve an important role in the supervisory review process - as a supervisory tool, informing the supervisor's understanding of the risk exposure and solvency position of the insurer.

IAIS Standards



- 13. An insurer should regularly perform its own risk and solvency assessment (ORSA) to provide the board and senior management with an assessment of the adequacy of its risk management and current, and likely future, solvency position.
- 14. The ORSA should encompass all reasonably foreseeable and relevant material risks including, as a minimum, underwriting, credit, market, operational and liquidity risks. The assessment should identify the relationship between risk management and the level and quality of financial resources needed and available.
- 15. As part of its ORSA an insurer should determine 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.
- 16. The insurer's risk management actions should be based on consideration of its economic capital, regulatory capital requirements and financial resources.
- 17. As part of its ORSA, an insurer should analyse 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.
- 18. Such continuity analysis should address a combination of quantitative and qualitative elements in the medium and longer-term business strategy of the insurer and include projections of the insurer's future financial position and analysis of the insurer's ability to meet future regulatory capital requirements.

Thank You



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