ORSA - The heart of Solvency II

Groupe Consultatif Summer School

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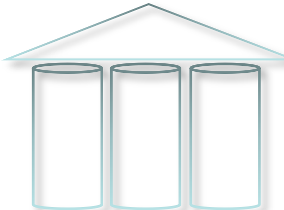
ORSA - The heart of Solvency II

- Developing the regulatory framework for Solvency II
- ORSA – it all starts from the top
- What is ORSA ?
- Input for the ORSA
- The steps of the process
- ORSA vs. internal models
- Group ORSA
- Summary

Developing the regulatory framework for Solvency II

Solvency I → Solvency II

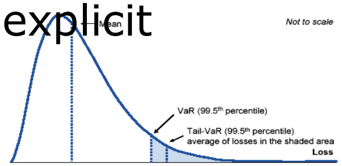


Solvency I

- Framework dates from the 1970s
- 14 Directives
- ‘Prudent’ valuation of liabilities reflect local accounting practices, non-harmonised valuation of TP
- Simple ‘volume-based’ capital requirements
- Asset risk managed by quantitative restrictions
- Diverging supervisory practices

Solvency II

- Three pillar structure
- A risk-based approach
- Unified legislative basis for prudential regulation of insurers & reinsurers
- Employs Lamfalussy arrangements
- Non-zero failure regime (explicit ruin probability)
- Two capital requirements
- Market consistent valuation
- Importance of risk management
- Streamlined group supervision



Developing the regulatory framework for Solvency II

eiopa

Group requirements

Pillar 1

Quantitative requirements

- Technical provisions (BE and risk margin)
- 2 capital requirements (MCR and SCR – SF/IM)
- Prudent person investment rule
- Own funds (3 tiers)

Total balance sheet approach
Market-consistent valuation
Approval of internal models

Pillar 2

Qualitative requirements

- Internal control
- risk management (incl. **ORSA**)
- Supervisory review process (qualit. & quant - add-ons)

Focus on firm's responsibility
Convergence of supervisory practices

Pillar 3

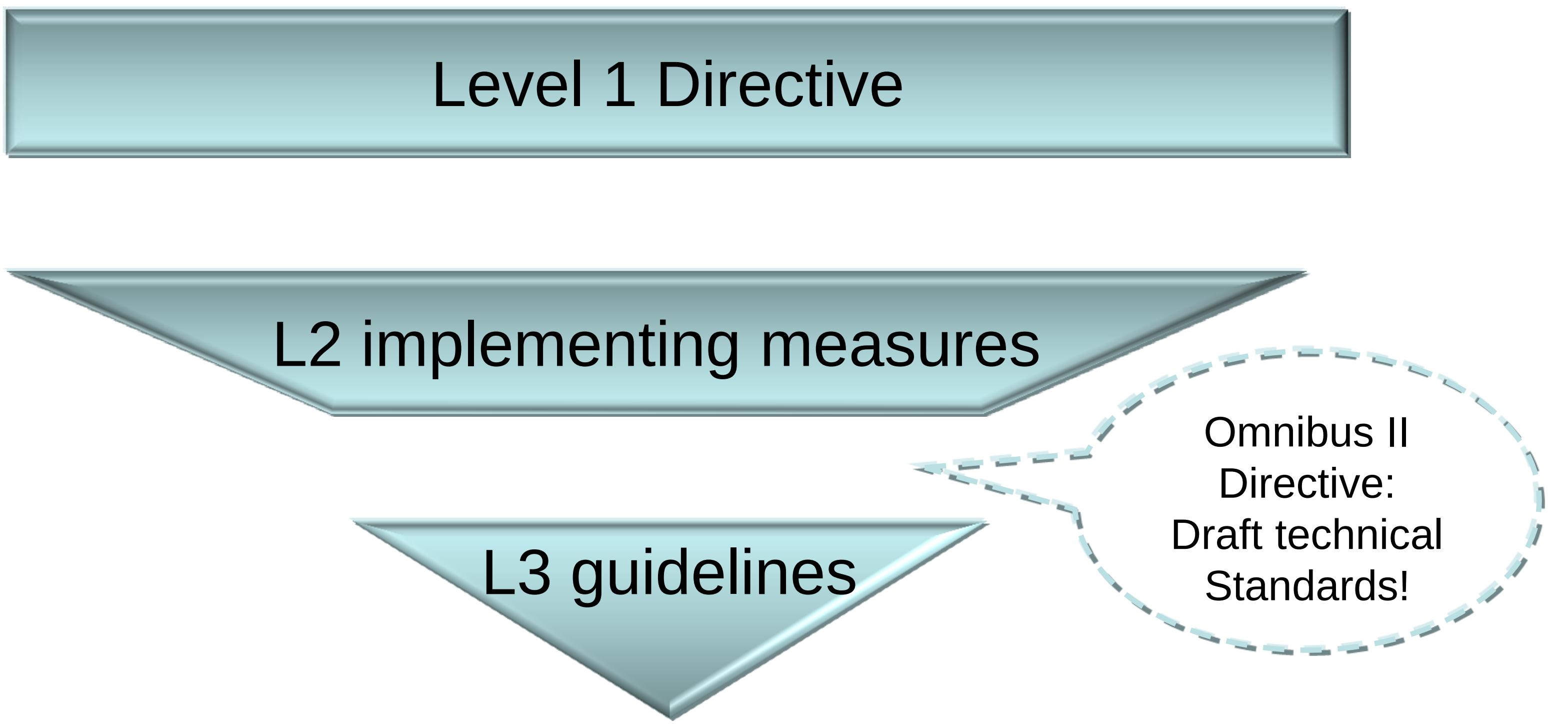
Reporting

- Supervisory reporting
- Public disclosure
- Market discipline

Convergence of supervisory reporting

More pressure from rating agencies, capital markets

Developing the regulatory framework for Solvency II



Developing the regulatory framework for Solvency II

- The new solvency regime **should not be too burdensome** for small and medium-sized insurance undertakings

- In Solvency II, proportionality is a general principle of supervision within the Directive:

  "Member States shall ensure that the requirements … are applied in a manner that is proportionate to the **nature, scale and complexity** of the risks …"

- This principle should **apply** both to the **requirements on undertakings** and **on the supervisory review process**

The proportionality principle

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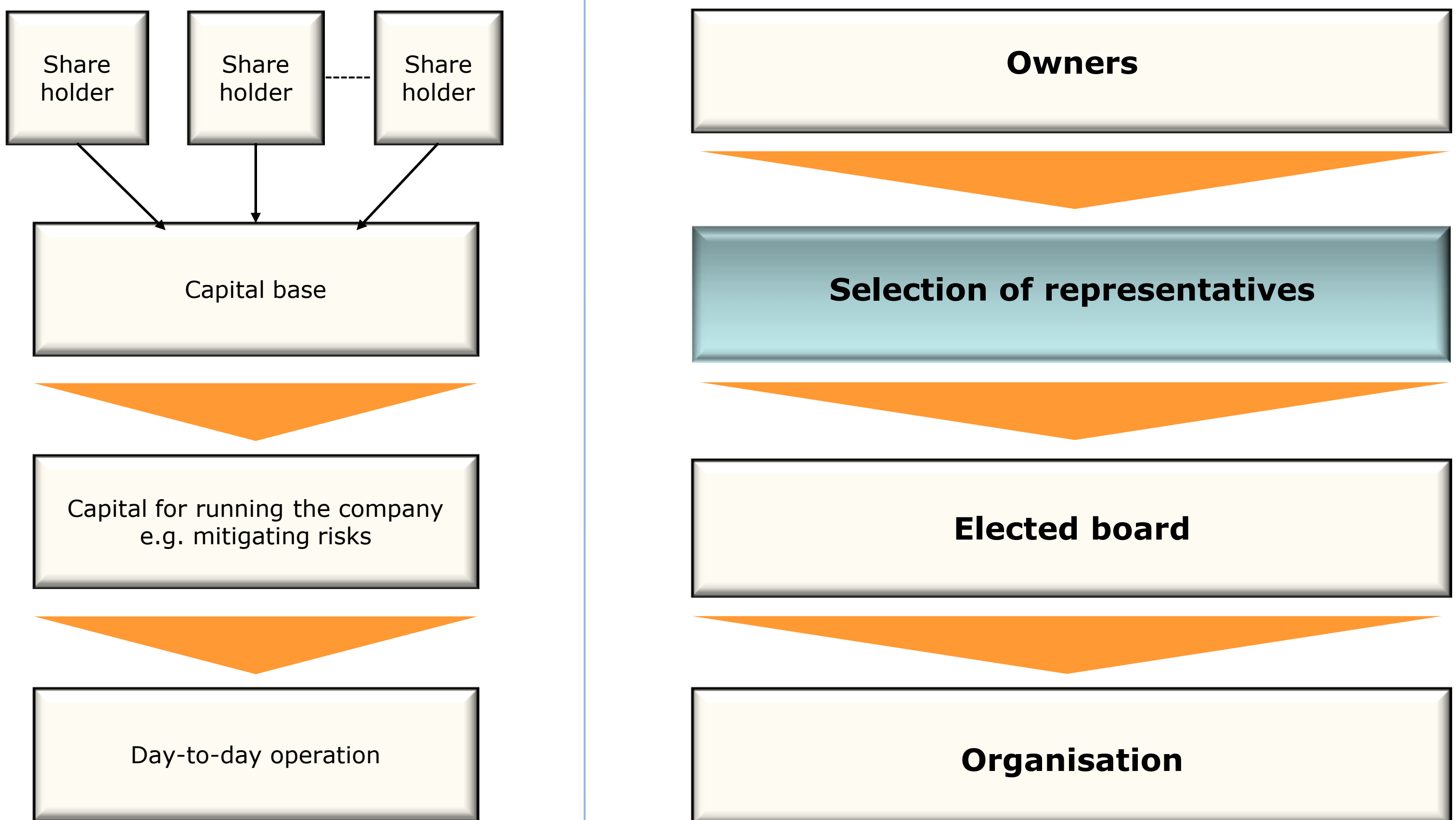
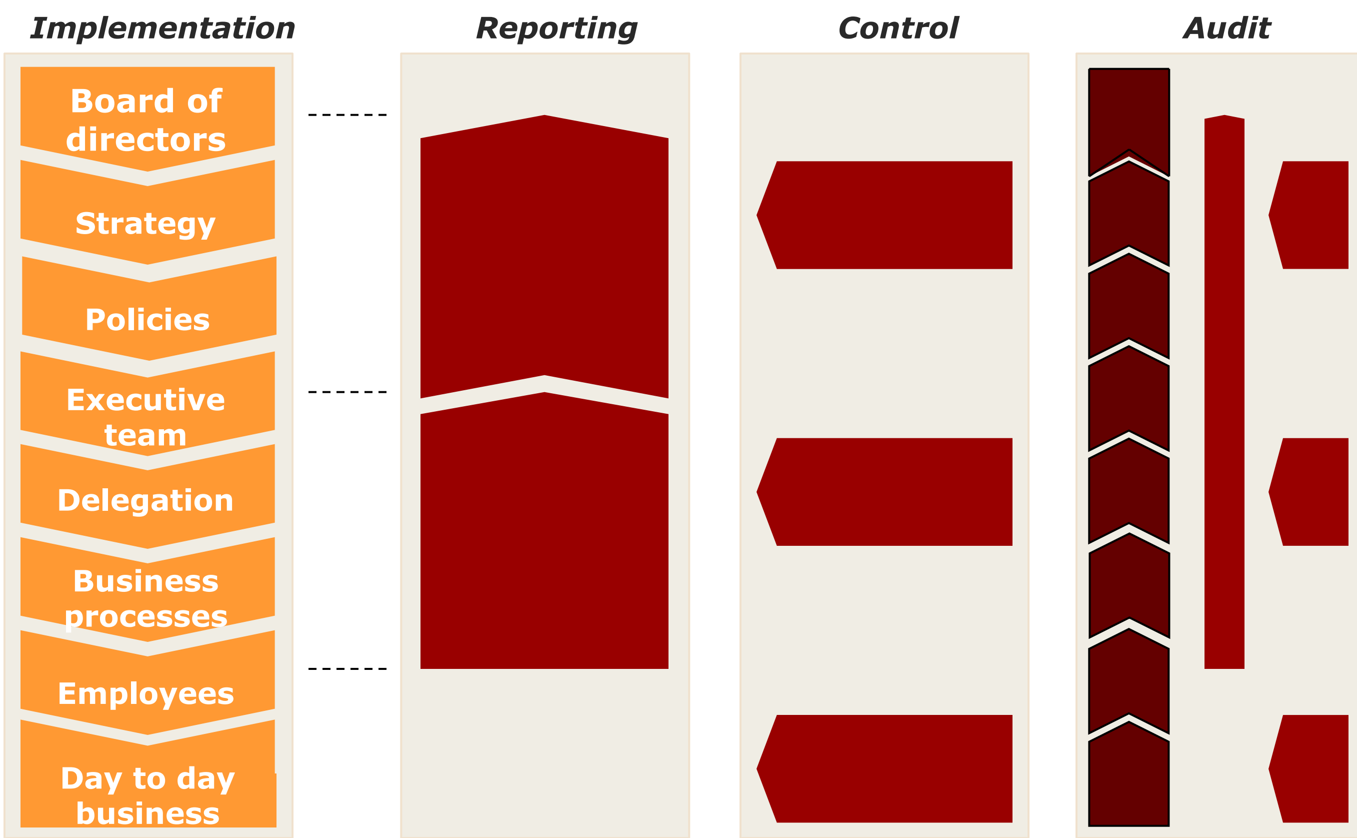
ORSA – it all starts from the top



It is core board responsibility not to take on more risks than the capital base is allowing

ORSA – it all starts from the top

By written procedures



Commentary

- What are the requirements corresponding to the risk appetite of the supervisory body?
- The requirements reflects how important the individual elements are.

Along with capital goes that employees need to be "fit" to solve the tasks given

ORSA – it all starts from the top

- **Are** the persons effectively running the undertaking's possibilities to use common sense and prudent thinking,
- **Are** the persons effectively running the undertaking's means to regain a comprehensive overview over the undertaking's risks and "Overall solvency need"
- **is** a key-function of the persons effectively running the undertaking
- **is** a ongoing, task where one of the outcome is to keep the persons effectively running the undertaking's aware of the impact of own risks on the overall solvency need at all time
- **is** a ongoing task, where one of the outcomes is to identify strengths and weaknesses in governance and in the organisation
- **is** a decision-process of how to mitigate risks by capital, reinsurance, organisational actions and other risk mitigating activities
- **is** a process which involves all persons effectively running the undertaking

ORSA – it all starts from the top

Introducing ORSA is a demanding task for the board

- Often boards are not fully aware of their capital responsibility
- The skills needed (achieving the complete and holistic risk picture) cannot be outsourced
- There is no mechanical way of conducting an ORSA
- Often a cultural change is needed both at the board and in the organisation
- It is not about getting experts into the board nor is it about reading highly technical documents from the organisation
- It is about obtaining confidence for that the board knows what company it is running and that the company can “afford” its strategic plan 3-5 years ahead including bumps on the way

ORSA – it all starts from the top

ORSA is changing the viewing angle from bottom up to top down

- A process for a complete and holistic risk understanding, viewed from the management or supervisory body
- Conveys a total picture of the company's risks, and gives the supervisor insight into the level of quality of the management or supervisory body's risk understanding
- Connects full risk picture with governance system and internal control system

ORSA is a top-down process owned by the board

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What is ORSA ?

- **is** a process for a overall and holistic risk understanding, viewed from the management and/or supervisory body
- **provide** a comprehensive picture of the company's risks
- **gives** the supervisor insight into the level of quality of the management and/or supervisory body's risk understanding
- **connects** full risk picture with risk management system and internal control system
- **is** a process which captures risks long time before they can be quantified
- **is** a process which uses unquantifiable knowledge about risks

What is ORSA ?

- **Is not** a new ruled-based solvency calculation
- **Is not** a pre-defined process. The undertaking needs to develop its own efficient assessment process within the framework of ”self-assessment”
- **Is not** a process – key-function – which as a starting point can be outsourced.
- **Is not** a process with one concrete number as output

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Input for the ORSA

- Risks can be described based on the undertaking's business model, assets and liability within a perspective of 3 to 5 years.
- Some essential risks – are: (See also Exhibit)
  - ✓ obligations/commitments expressed in terms of SCR-standardmodel risk-calculation (UW-risks, risks connected to technical provisions, all sorts of market risks, risks connected to counterparties, liquidity risks, operational risks etc.)
  - ✓ insufficient capital; mis-match between liabilities and assets
  - ✓ future risks within a time-horizon of 3 to 5 year
  - ✓ risks of pleading joint and several liabilities
  - ✓ off-balance guarantees
  - ✓ lose of staff, employees with wrong/low competences etc.
  - ✓ bad functioning systems, lack of control systems
  - ✓ Lose of reputation
- The undertaking's ability to assess

Exhibit 1. Examples of risks

Insurance risks

- Underwriting risks
- Reinsurance risks
- Technical provisions risks
- Cumulated risks
- Catastrophe risks
- Legal risks
- Other insurance-risks

Market risks

- Interest risk assetts
- Interest risk liability
- Share risk
- Property risk
- Currency risks
- Other market risks
- Derivatives

Counterparty risks and other risks

- Credit risks
- Risk-concentration
- Concern-risks
- Liquidity risks
- Operational risks
- Control risks
- Size risks
- Derivatives

- Run-off risks
- Strategy risks
- Reputation risk
- Profit risks
- Growth risks
- External risks

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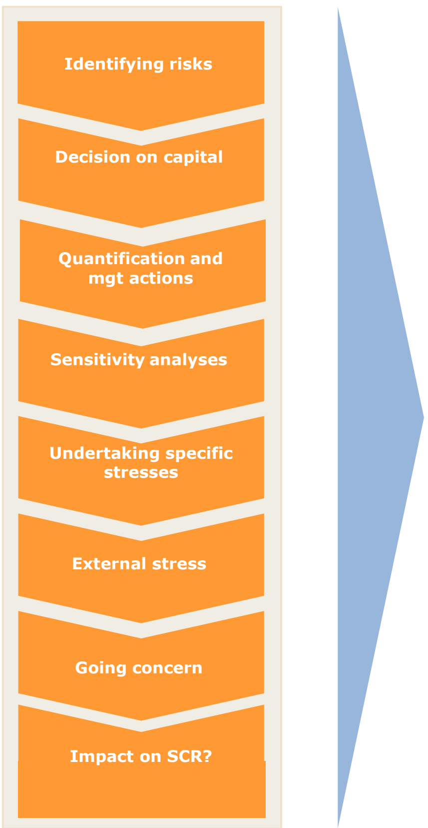
The steps of the process (in two-tier system) (1)

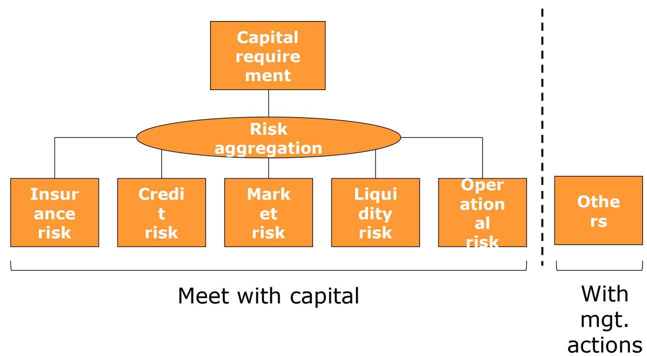
Process steps	
Identifying risks	**B:** "What are the risks that this company might face during the strategic planning period (e.g. 3-5 years)?" **E:** Delivers an overall picture of the risks pronounced in quantitative figures and qualitative terms
Decision on capital	**B:** Decision on which risks are mitigated by capital and which are mitigated by management actions only (e.g. reputational risk) **E:**
Quantification and mgt actions	**B:** Asks to quantify risks and develop suitable management actions for non-capital covered risks **E:** Quantifies risk by use of the organisation and develops suitable management actions
Sensitivity analyses	**B:** "How robust is the assessment of risks? What is the quality of key processes involved (e.g. claims handling)? **E:** Conducts sensitivity analyses and calculates impact on capital needs
Undertaking specific stresses	**B:** "What are possible future scenarios that we will have to navigate and what is the likely impact?" **E:** Conducts undertaking specific stress tests and calculates impact on capital needs as well as developing suitable management actions
External stress	**B:** "What external stresses have not been taking into account already?" **E:** Conducts external stresses, some of which might be contained in the SCR-calculation, and calculates impact on capital needs as well as developing suitable management actions
Going concern	**B:** "What are the key assumptions underlying going concern?" **E:** Identifies key assumptions
Impact on SCR?	**B:** "Is the resulting understanding of risks and assumptions reflected in the basis (assumptions, structure, model) for the standard SCR-calculation or internal model, respectively **E:** Evaluates impact and modifies SCR-calculation if needed

B: Board of directors
E: Executive team (by use of the organisation)

Outcome of the ORSA (1)



Risk picture



Management actions for future scenarios

- Develop risk awareness and contingency planning on a regular basis

Overall solvency needs

- Expressed i quantitative and qualitative terms
- Connects business planning to overall solvency needs
- Explicit identification of possible future scenarios
- Managing external stress
- Assess quality of processes and input

"Proof" of SCR-calculation

- Review assumptions for SCR-calculation
- Review risk picture in SCR-calculation

Impact on strategy

- Review assumptions for business model
- Review control and governance

The steps of the process in a going concern (2)

Process steps

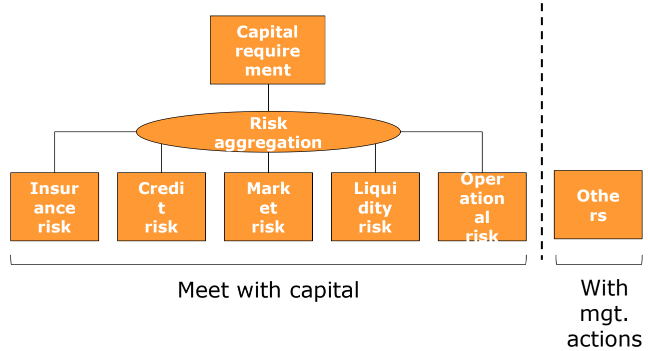
Identifying risks See fx Exhibit	The Board initiate a systematic and organised identification of all actual risks as well as the risks the organisation expects according to the business strategy and the time horizon
Review and analysing of risks	Risk analyses and description of possibilities to mitigate risks or cover these with other risk mitigating activities than capital (ALM-activities, business-guidelines, other compensatory actions, etc). Assessment of essential deviations from SCR.
Risks and Business model	The Board assess the risks considering the business model. The risks are specified into quantitative and qualitative terms at the end of every year during the strategy period
Sensitivity analyses	Sensitivity analysis are performed and the solvency impact are calculated. Considerations about the qualities of the undertakings different activities are assessed. (The underwriting process, the reinsurance cover, the claims-handling, the asset- and liability-management, etc)
Undertaking specific stresses	The Board assesses the effect of different scenarios and activities, and they decide how to meet these risks (by capital and/or management actions)
The decision	Is the result of understanding risks and assumptions reflected in the basis (assumptions, structure, model) for the standard SCR-calculation or internal model, respectively The Board decides the risk strategy for every specific risk, considering its nature and the undertakings own funds/capital base
Impact on strategy?	Output of the ORSA-process is continuously being incorporated into the business-model, into SCR and into the control- and governance system

Outcome of the ORSA (2)

Process steps

- **Identifying risks See fx Exhibit**
- **Review and analysing of risks**
- **Risks and Business model**
- **Sensitivity analyses**
- **Undertaking specific stresses**
- **The decision**
- **Impact on strategy?**

Risk picture



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ORSA vs. internal models

The balance between models and leadership

Models cannot replace leadership !

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Group ORSA

Possibility of a **single ORSA document** (art. 246 Solvency II Directive) :

Where the participating insurance or reinsurance undertaking or the insurance holding **company so decides**, and **subject to the agreement of the group supervisor**, it may undertake any assessments required by Article 45 at the level of the group and at the level of any subsidiary in the group at the same time, and may produce a **single document** covering all the assessments.

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Summary

- ORSA is a top-down process **owned** by the board
- ORSA is changing the viewing angle **from bottom up to top down**
- ORSA is **connecting** Business strategy and capital planning
- It is core board **responsibility** not to take on more risks than the capital base is allowing
- Two main goals: The board should **know** that the company can “afford” its strategic plan 3-5 years ahead including bumps on the way and the board should **know** how to execute its strategic plan
- Introducing ORSA is a **demanding** task for the board
- There is no **fixed** recipe for an ORSA
- ORSA is not an internal model
- ORSA is an integral part of the business strategy and needs to be **performed** at least **annually**, has to be performed whenever the risk profile **changes** significantly, has to be **documented** and has to be **reported** to the supervisor

Appendix

Guidelines step-by-step

Guidelines step-by-step

Principle of proportionality

Guideline 1 (Article 45 (2) of the Directive)

The undertaking should develop its own efficient processes for the ORSA, tailored to fit into its organisational structure and risk management system with appropriate and adequate techniques to assess its overall solvency needs.

Role of the Management Body (top down approach)

Guideline 2 (Article 45 of the Directive)

The undertaking should ensure that the management body takes an active part in the process by managing how the assessment is to be performed and challenging its results.

Documentation

Guideline 3 (Article 45(2) of the Directive)

The undertaking should have in place at least the following documentation on the ORSA:

- ORSA policy;
- Record of each ORSA process;
- Internal documentation of ORSA information;
- Information to be disclosed and reported to the supervisor.

Guidelines step-by-step

Documentation - continued

Guideline 4 (Article 45(2) of the Directive)

The ORSA policy should comply with the guidelines established under General Governance – written policies – and include additionally at least:

a) a description of the processes and procedures in place;

b) a description of the linkage between the risk profile, the risk tolerance limits and the overall solvency needs;

c) details on:

(i) how often stress tests/sensitivity analyses are to be performed and what tests/ analyses are to be used;

(ii) the assumptions on which the assessment and the aggregation of risks are to be based;

(iii) a description of the data sources on which the process relies and the criteria and methodologies for assessing the quality of the data used;

(iv) the frequency for the performance of the (regular) ORSA and the circumstances which would trigger the need for an ORSA outside the regular timescales (non-regular).

Guideline 5 (Article 45 of the Directive)

The ORSA process and outcome should be appropriately evidenced and internally documented. The process should also be regularly independently reviewed.

Documentation continued

Guideline 6 (Article 45 of the Directive)

Information on the results and conclusions regarding the overall solvency needs assessment, the compliance with regulatory capital requirements and with the requirements regarding technical provisions should be communicated to the management body, senior management and to any other staff for whom the information is relevant.

Overall Solvency Needs

Recognition and Valuation Bases

Guideline 7 (Article 45(1)(a) of the Directive)

If the undertaking in its assessment of its overall solvency needs uses a recognition and valuation basis different from the Solvency II basis, the undertaking should explicitly analyse and justify the relevance and impact of its own recognition and valuation basis compared to the Solvency II basis. It should quantitatively reconcile the results of the recognition and valuation process with the Solvency II basis.

Guideline 8 (Article 45(1) (a) of the Directive)

The undertaking should express the overall solvency needs in quantitative terms and complement the quantification by a qualitative description of the risks.

Guidelines step-by-step

Recognition and Valuation Bases - continued

Guideline 9 (Article 45(1) (a) of the Directive)

The undertaking should quantify risks for a sufficiently wide range of outcomes, not only the most likely, using appropriate techniques which provide an adequate basis for risk and capital management purposes.

Forward-looking perspective

Guideline 10 (Article 45 of the Directive)

The undertaking's own risk and solvency assessment should be forward-looking and cover the capital needs the undertaking faces over each year taking into account its business plans and projections.

Regulatory Capital Requirements

Guideline 11 (Article 45(1)(b) of the Directive)

The ORSA should include procedures that enable the undertaking to reliably monitor its compliance with regulatory capital requirements whilst taking into account potential future changes in the risk profile and considering stressed situations. When applicable, the capital plans and procedures should also cover a run-off situation.

Guidelines step-by-step

<u>Technical provisions</u>

Guideline 12 (Article 45(1)(b) of the Directive)

As part of the ORSA process the undertaking should ensure that the actuarial function provides input concerning compliance with the requirements for the calculation of technical provisions and the risks arising from this calculation.

<u>Deviations from assumptions underlying the SCR calculation</u>

Guideline 13 (Article 45(1)(b) of the Directive)

The undertaking should consider whether the use of the standard formula, including any undertaking-specific parameters, or a full or partial internal model for the calculation of the SCR is appropriate given the specific risk profile of the undertaking.

Guideline 14 (Article 45(1)(b) of the Directive)

The undertaking may initially assess deviations between its risk profile and the assumptions underlying the SCR calculation on a qualitative basis. If this assessment indicates that the undertaking’s risk profile deviates materially from the assumptions underlying the SCR calculation the undertaking should quantify the significance of the deviation.

The term ”internal model” refers to an approved (full or partial) internal model according to Articles 112 to 126.

Guidelines step-by-step

Internal Model Users\Deviation from assumptions underlying the SCR calculation

Guideline 15 (Article 45 (3) of the Directive)

In the ORSA the undertaking should ensure the on-going compliance of the internal model with changes related to new tests and standards. The undertaking should question whether any model changes/updates are required as a result.

Link to the management process and decision-taking framework

Guideline 16 (Article 45(4) of the Directive)

The undertaking should take the results of the ORSA and the insights gained in the process into account for longer term capital management, own funds' allocation, business planning, product development and design and governance.

Frequency of the ORSA

Guideline 17 (Article 45(5) of the Directive)

The undertaking should perform the ORSA at least annually. Notwithstanding this, the management body has to establish the frequency of the assessment particularly taking into account the undertaking's risk profile and the volatility of the overall solvency needs relative to the capital position. It should justify the adequacy of the frequency of the assessment.

Group specificities of the ORSA

Scope of the Group ORSA

Guideline 18 (Articles 213 and 246(4) of the Directive)

The group should design the Group ORSA to reflect the nature of the group structure and its risk profile. All of the entities that fall within the scope of the group supervision should be included within the scope of the Group ORSA. This includes both (re)insurance and non-(re)insurance undertakings, both regulated and non regulated entities, entities situated in the EEA and non-EEA entities.

Reporting to Supervisors

Guideline 19 (Article 153 of the Directive)

The document sent to the group supervisor with the outcome of the Group ORSA should be in the same language as the Group RSR.

Where any of the subsidiaries has its head office in a Member State whose official languages are different from the languages in which the Group wide ORSA is reported, the supervisory authority concerned may, after consulting the group supervisor, require the undertaking to include a translation of the part of the ORSA information concerning that subsidiary into an official language of that Member State unless exemption has been granted by the supervisory authority concerned.

Subsidiaries should produce their ORSA in the language(s) determined by the group supervisor or in the language of the group supervisor which decides after consultation with the college of supervisors.

Guidelines step-by-step

<u>Overall Solvency Needs</u>

Guideline 20 (Article 45 of the Directive)

The group should adequately capture all specificities of the group, including group specific risks and the interdependencies within the group and its impact in the group risk profile.

Guideline 21 (Article 45(2) of the Directive)

In the Group ORSA the group should outline how the group specificities are identified, addressed, managed, monitored, reported, captured and escalated.

<u>Forward-looking perspective</u>

Guideline 22 (Article 45 of the Directive)

In the context of the Group ORSA the group should set the time horizon for the group and explain how the different time horizons used by group undertakings on the solo level influence the group's forward-looking perspective.

<u>Regulatory Capital Requirements</u>

Guideline 23 (Articles 13(37) and 104(4) of the Directive)

The group should adequately explain the drivers of any diversification effects in the group SCR.

Guidelines step-by-step

Internal model users

Guideline 24 (Article 45(3) of the Directive)

The group should describe entities which do not use the group internal model separately from entities which use the group internal model in the Group ORSA.

Link to management processes and decision taking framework

Guideline 25 (Article 246(4) of the Directive)

Group supervisors, after consulting the college of supervisors, may allow groups to report the Group ORSA according to business lines instead of according to legal entities under the proviso that all legal entities are first identified and then allocated to the relevant business lines.

Criteria for a single ORSA document

Guideline 26 (Articles 246(4) and 248 to 252 of the Directive)

The group supervisor should consider the following criteria when, after consulting the College and the group itself, it gives its agreement for a single ORSA document:

a) a group internal model has been approved both for the calculation of group and subsidiaries' SCR in accordance with Article 231 and no solo supervisors have required the use of a standard formula;
b) the time horizon, risk measure, level of confidence and reporting date should be the same for the same business lines no matter whether they are considered in the group or the subsidiary context;
c) the results of each subsidiary should be individually identifiable in the foreseen structure of the single ORSA to enable a supervisory review process at the solo level;
d) the group wide ORSA process must give reasonable assurance of the prudent risk and solvency assessment of the solo undertakings belonging to the group;
e) the supervisory authorities concerned may require the parent undertaking to ensure that the documentation provided satisfies the requirements at group and solo level.

Criteria for a single ORSA document – continued

Guideline 27 (Article 246(4) of the Directive)

When asking for the agreement to provide a single ORSA document, the group should provide an explanation on how the subsidiaries are covered and how the subsidiaries' management boards are involved in the assessment process and approval of the outcome.

Guideline 28 (Article 246(4) of the Directive)

The group should ensure that the single ORSA document is appropriate for solo supervisors by establishing different parts, so that each subsidiary is easily identifiable.

Guideline 29 (Article 227(1) of the Directive)

In the Group ORSA the group should assess the risks of the business in third countries in the same manner as for EEA-business with special attention to transferability and fungibility of capital and – in case of equivalence – the consequences of applying local capital requirements and technical provision calculations instead of the Solvency II framework in third countries.

EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY

Thank you!