EIOPA Consultation Paper on the proposal for guidelines on Forward Looking Assessment of the undertaking's own risks

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EIOPA's consultation paper on guidelines for a forward looking assessment of the undertaking's own risk closely mirrors Solvency II ORSA guidelines but requires firms to calculate and monitor Solvency II Pillar 1 metrics

INTRODUCTION

On 27 March 2013, the European Insurance and Occupational Pensions Authority (EIOPA) launched a consultation on guidelines for the preparation for Solvency II. The purpose of the consultation is to *"support both National Competent Authorities (NCAs) and undertakings in their preparation for the Solvency II requirements"* with the aim of ensuring a consistent and convergent approach in preparations.

The consultation covers guidelines for the phased introduction of specific aspects of the Solvency II requirements into national supervision from 1 January 2014, in advance of the full implementation of the Solvency II regime. The guidelines are set out in four consultation papers and accompanying explanatory text covering:

- System of governance;
- Forward looking assessment of the undertaking's own risk (based on Own Risk and Solvency Assessment ("ORSA") principles);
- Submission of information to NCAs; and
- Pre-application for internal models.

The consultation will run until 19 June 2013 with final guidelines expected to be published by EIOPA in autumn of this year.

To assist you in digesting these consultation papers, Milliman has prepared a series of summary papers covering each of the consultation papers separately. This summary paper covers the guidelines on the forward looking assessment of the undertaking's own risks.

FORWARD LOOKING ASSESSMENT OF THE UNDERTAKING'S OWN RISKS

The introduction of a forward looking assessment of the undertaking's own risks is based on the draft ORSA guidelines issued by EIOPA in July 2012 and covers three main aspects:

1. Assessment of overall solvency needs;
2. Assessment of whether the firm would comply with Solvency II regulatory capital requirements and technical provisions on a continuous basis; and
3. Assessment of deviations from the assumptions underlying the solvency capital requirement ("SCR") calculation.

The forward looking assessment should ensure that the firm engages in the process of *"assessing all the risks inherent in its business and determining its corresponding capital needs"*. This requires firms to have in place adequate and robust processes to assess, monitor and measure their risks and overall solvency needs. Fundamentally, these processes need to be fully embedded within the business as part of the decision-making process of the firm.

The guidelines emphasise that the assessment should be bespoke to the firm and, as such, there is no fixed way specified for structuring this. Despite this, specific supervisory expectations are set out in relation to the continuous compliance with the regulatory capital and technical provisions and the assessment of any deviation between the firm's risk profile and the assumptions underlying the SCR calculation.

The assessment should be conducted on a solo or group basis, starting in 2014, and performed on a regular basis (at least annually) and immediately following any significant change in the risk profile of the firm.

EIOPA has stressed that the guidelines do not require NCAs to take supervisory action in relation to any of the outcomes from the requirements, particularly where these may reflect a failure to comply with Solvency II Pillar 1 requirements. The guidelines are intended to be applied by NCAs in a proportionate manner and allow for flexibility in application through provisions for "phasing-in" and the use of specific thresholds.

OVERVIEW OF GUIDELINES

The consultation paper sets out 25 guidelines for the preparation of a forward looking assessment consistent with the forthcoming requirements under Article 45 of the Solvency II Directive.

The overall emphasis of the guidelines remains consistent with EIOPA's final report on the ORSA guidelines, published in July 2012, with all 21 guidelines in the final report replicated within the consultation paper. In addition, 3 initial guidelines are included covering the general provision for the Guidelines, the need for NCA's to provide a process report to EIOPA and thresholds for the forward looking assessment.

A further new guideline has been introduced covering the supervisory report of the forward looking assessment (guideline 10). This requires firms to submit a report to the NCA within two weeks of completing the assessment setting out at least:

- The qualitative and quantitative results of the assessment and the conclusions drawn;
- The methods and main assumptions used;
- A comparison between the overall solvency needs, the regulatory capital requirements and the firm's own funds (where applicable subject to the specified thresholds).

THRESHOLDS

Thresholds have been specified such that at least 80% of the market share in each member state, and groups with more than EUR 12 billion of total assets, should be subject to the assessment of whether the firm would comply on a continuous basis with the Solvency II SCR and technical provisions, and an assessment of deviations from the assumptions underlying the SCR calculation (for firms not in the internal model pre-application process). EIOPA notes that these requirements will also be subject to "phasing-in", such that different expectations would be placed on the assessment produced in 2015 relative to that produced in 2014.

EIOPA's opinion paper, published in December 2012, set out the intention that firms would be required to put in place "an effective system of governance which provides for sound and prudent management of the undertaking and an effective risk management system including a forward looking assessment of the undertaking's own risks (based on the ORSA principles)". This opinion has been interpreted by many to relate to the implementation of the governance elements and to focus on the qualitative assessment of risk.

However, the scope of these guidelines appears much more wide ranging potentially requiring firms to implement large parts of the Solvency II framework in advance of the official implementation date.

CONNECTION TO SOLVENCY II PILLAR 1 REQUIREMENTS

Throughout the guidelines, reference is made to Solvency II Pillar 1 items. Specifically, firms are required to assess the adequacy of regulatory capital position (represented by the Minimum Capital Requirements ("MCR") and SCR) and to determine whether they will be able to meet these requirements once the Solvency II quantitative requirements are applied. The explanatory text explains that in order to assess compliance on a continuous basis with regulatory capital requirements (as required under guideline 14) and technical provisions (guideline 15), the regulatory capital and technical provisions must be determined in line with the relevant Solvency II principles. Furthermore, in order to determine capital compliance, firms are required to assess the quality and quantity of their own funds.

Firms must also assess any deviation between their risk profile and the assumptions underlying the SCR calculation as part of the assessment. The explanatory text explains that technical specifications for the calculation of the regulatory capital requirements and technical provisions will be provided together with information on the assumptions on which the SCR is based. While NCAs are not required to take supervisory action based on a failure to comply with Solvency II Pillar 1 requirements, where significant deviations exist firms are expected to consider how these could be addressed as part of the preparatory period.

As these aspects rely on the conclusion of negotiations surrounding the Omnibus II Directive and the availability of Delegated Acts, EIOPA has stated it will review the deadline for the report on the forward looking assessment at the end of 2013.

Direct connections between the forward looking assessment and Solvency II Pillar 1 requirements appear to effectively bring many parts of the Solvency II Pillar 1 requirements in by the back door. This appears to go beyond expectations formed following EIOPA's opinion paper and is likely to be a considerable concern to many firms.

Such calculations may be a challenge for many firms within the timescales given the lack of finalised guidance. While EIOPA has committed to revisiting the timescales at the end of 2013, in order to assess whether sufficient regulatory guidance will be available, we note that these timings will depend heavily on the outcomes from the long-term guarantee assessment and whether the results from this enable the Omnibus II process to move forward.

The reporting timescales imposed on NCAs in the guidelines may suggest that firms will be required to produce Solvency I and Solvency II assessments in parallel potentially over an extended period until Solvency II is fully implemented.

USE OF THE FORWARD LOOKING ASSESSMENT

Guideline 17 requires firms to ensure that the results and insights from the forward looking assessment are used throughout the business, and at least in:

- Capital management;
- Business planning; and
- Product development and design

The explanatory text details that any "strategic or other major decisions that may materially affect the risk or own funds' position of the undertaking need to be considered in the context of the forward looking assessment before such a decision is taken".

Guideline 17 effectively requires firms to manage key parts of their business with consideration of the forward looking assessment. The results and insights of the assessment will be gathered through consideration of Solvency II Pillar 1 items.

Despite this, firms will still be required to manage their business according to Solvency I requirements up until the point when Solvency II is fully implemented. As a result, these guidelines effectively require firms to implement a period of parallel running in order to comply with both measures.

With no fixed implementation date for Solvency II currently available, we note that any such parallel running may be in place for an extended period of time.

We note that this issue was commented on by Insurance Europe in their recent letter to EIOPA who highlighted the concern that such an approach would mean the costs of Solvency II would become apparent well in advance of any perceived benefits.

DOCUMENTATION

Firms must maintain the following documentation for the forward looking assessment:

- Policy for the forward looking policy;
- Record of each forward looking assessment;
- An internal report on each forward looking assessment; and
- A supervisory report of the forward looking assessment.

These do not require new, or fully separate, documents to be created, but can refer to existing documentation where these contain the relevant information.

The content of the documentation for the assessment is fully in line with the Solvency II ORSA requirements. The supervisory report should be submitted to NCAs by firms within two weeks of having conducted the assessment.

SUMMARY

EIOPA's publication of a consultation paper on guidelines for the introduction of a forward looking assessment of undertaking's own risks is intended to ensure a consistent and convergent approach in preparations for Solvency II.

The guidelines are largely consistent with the ORSA requirements which require firms to ensure that they engage in the process of assessing all the risks inherent in their business and determining their corresponding capital needs.

Despite this, these guidelines appear to go wider than expected, potentially requiring firms to implement large parts of the Solvency II framework in advance of the official implementation date.

The guidelines make many direct connections between the forward looking assessment and the Solvency II Pillar 1 requirements. This may lead to the concern that EIOPA is effectively bringing many parts of the Solvency II Pillar 1 requirements in by the back door.

Companies face significant challenges in projecting their technical provisions, own funds and capital requirements, especially within the 2014 deadline.

Furthermore, the proposal for firms to manage key parts of their business with consideration of the forward looking assessment looks likely to add further costs and confusion by introducing further dynamics into decision making processes.

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