EIOPA Consultation Paper on the Proposal for Guidelines on ORSA

November 2011

The release of EIOPA's consultation paper on the ORSA process marks the first public consultation of the Solvency II Level 3 text.

INTRODUCTION

On 7 November 2011, EIOPA released a public consultation paper on the proposal for guidelines on Own Risk and Solvency Assessment (ORSA), the first public consultation on the draft Solvency II Level 3 text.

This paper expands the guidance set out in Article 45 of the Level 1 Directive to provide guidance on what companies should do to ensure that the outcome of the Own Risk and Solvency Assessment (ORSA) is acceptable.

The content of this consultation paper was originally developed through an informal pre-consultation process in December 2010. An annex to this consultation paper summarises the results of an impact assessment conducted by EIOPA on the issues identified from the feedback received during this earlier process and highlights how the current consultation paper reflects this input. A second annex summarises specific questions that EIOPA is seeking further feedback on from stakeholders.

To assist you in digesting the draft guidelines, Milliman has provided this short summary of the content of this paper including a brief analysis of what we expect the content of this document to mean for companies.

OWN RISK AND SOLVENCY ASSESSMENT

The paper indicates that it is up to each organisation to determine how the ORSA is carried out and so the guidelines focus on the desired outcomes of the ORSA process rather than how the ORSA is to be performed (and this focus was highlighted as the main result from the impact assessment). The guidelines are relevant whether the standard formula or an internal model is used, but the paper clearly states that those with an internal model must use it within the ORSA process and, through that, challenge the model's ongoing appropriateness.

The paper focuses on identifying and assessing firms' "overall solvency needs" (rather than just capital needs), highlighting the need to distinguish between risks which firms propose to cover with capital and those which will be managed through other risk mitigation techniques. The principle of proportionality should be reflected throughout the ORSA, not just in the level of complexity of the methods used but also in the frequency with which the ORSA is performed. It should be noted that an ORSA should be performed at least annually and should trigger a corresponding SCR calculation.

We note that the paper sets out 24 guidelines, down from the 29 guidelines set out in the December 2010 pre-consultation paper. Companies already making significant progress with their ORSA based on the guidelines set out in the pre-consultation paper will be pleased to note that this consultation paper closely follows the previous text and does not appear to add any significant additional requirements.

Rather, we note, a number of specific guidelines have been removed from the current draft text relating largely to the guidance for supervisors in relation to their review of firms' ORSA processes and outputs.

ORSA GUIDELINES

The first 15 guidelines relate to both individual firms and groups:

- The ORSA process needs to be efficient and tailored to fit the needs of each firm with approaches that permit the firm to assess its overall solvency needs.
- The administrative, management or supervisory body (AMSB) of the firm has to play an active role in deciding how the assessment is to be performed and in challenging the results.
- Documentation of the ORSA should include at least: an ORSA policy; a record of each ORSA process; an internal report on the ORSA; and, an ORSA supervisory report.
- The ORSA policy has to at least cover: ORSA processes and procedures; link between risk profile, tolerance limits and overall solvency needs; and, information about stress tests and data quality. It should also describe the triggers for an ad-hoc ORSA as well as the regular frequency.
- The ORSA process and outcome must be evidenced and documented (although the requirement for regular independent review has been removed).
- Once signed off by the Board, information on the results and conclusions of the ORSA must be provided to staff for whom it is relevant.
- An explanation is needed where a different recognition and valuation basis is used from the Solvency II basis, and in particular why it better fits the company's risk profile, etc. While companies are not bound to use the correlations set out in the standard formula in the assessment, if company-specific parameters are used in the SCR then they should also be used in the overall solvency needs assessment.
- Overall solvency needs have to be quantified and accompanied by a qualitative description of the risks. The effectiveness of risk mitigation should be allowed for.
- Risks should be quantified for a sufficiently wide range of stress test/scenario analyses to provide an adequate basis for the overall solvency needs.
- The ORSA must be forward-looking to identify overall solvency needs each year under the business plan and projections. This should provide analysis of the firm's ability to remain a going concern, both over the business planning period and potentially over a longer time horizon.
- The ORSA process should reliably monitor compliance with regulatory capital requirements on a continuous basis, allowing for changes in risk profile and possible stressed conditions, as well as allowing companies to monitor and manage the quality and loss absorbing capacity of own funds.
- The actuarial function should provide input regarding compliance with the requirements for calculating technical provisions.
- An assessment of deviation between the risk profile and the SCR calculation can be made qualitatively initially, but must be quantified if material.
- The ORSA results and insights from the process must be integrated into long term capital planning, own funds allocation, business planning, product development and design and governance.
- The firm should decide the frequency of the ORSA based on its needs (must be at least annual).

The last 9 guidelines relate to Groups:

- Group ORSAs should reflect the Group structure and risk profile.
- The Group ORSA must be sent to the supervisor in the same language as the Group RSR (regular supervisor reporting).
- The Group should adequately identify, measure, monitor, manage and report all group-specific risks and interdependencies within the Group.
- Key drivers of overall solvency needs and any diversification effects must be explained.
- The Group ORSA must set the time horizon for the group and describe how solo companies fit into that.
- Entities which do not use the group internal model should be described separately from those that do, and reasons for this set out in the Group ORSA report.
- If a single ORSA document is used, an explanation is required of how subsidiaries' management is engaged and how business activities map across business units and regulated entities.
- Groups should ensure adequate and clearly identifiable documentation is available for each solo company reported in the group ORSA.
- The Group ORSA should address the risks of the business in third countries in the same way as EEA business or unregulated entities, noting any features of capital fungibility and calculation requirements for technical provisions.

We note that the AMSB is expected to engage significantly in the ORSA process since it is one of its main tools for monitoring and influencing the risk profile of the business. The paper sets expectations that the Board will challenge the identification and assessment of risks and the translation of these into capital requirements or management actions. They are also expected to actively challenge the SCR assumptions and calculation to test its appropriateness.

The requirement for the Board to be sufficiently knowledgeable about risk and capital management that was included in the pre-consultation draft has not made it through to this consultation paper. While this is no longer specified here, it continues to be required under the current Level 2 text which states that the Board should collectively possess the necessary "qualifications, competency, skills and professional experience in the relevant areas of the business in order to effectively exercise sound and prudent management".

ORSA DOCUMENTATION

The ORSA must be adequately documented, including at least the following documentation:

- An ORSA policy
- A record of each ORSA process
- An internal report on the ORSA
- An ORSA supervisory report (which may be based on the internal report if this is sufficiently detailed)

The record of the ORSA process is expected to contain a range of items related to overall solvency needs and capital sources, risk profile (including how these compare to the assumptions underlying the SCR calculation), management of risks not covered with own funds, action plans arising, and a description of the challenge process conducted by the Board. The level of detail provided should enable a third party to evaluate the assessments carried out.

The ORSA has to consider the overall solvency needs in light of the business plan, risk profile, risk limits, and obligations to policyholders. Projections have to consider likely changes to business strategy and risk profile over the business planning period as well as sensitivities to the assumptions used. Firms should indentify which risks will be covered with capital (determining the level of capital required for material risks and explaining how these risks will be managed), which will be managed with risk mitigation tools (explaining how and why this will be done), and which will require a combination of both.

The ORSA will need input from across the firm and differs from the SCR in the scope of risks considered and the fact that non-quantifiable risks should also be assessed. The internal ORSA report must be sufficiently detailed such that it informs the strategic decision making process.

REGULATORY CAPITAL REQUIREMENTS

The ORSA should include processes to allow firms to reliably monitor continuous compliance with regulatory capital requirements and to assess the quality and loss absorbing capacity of own funds over the whole of the business planning period.

We note that, while the paper sets out the need for companies to reliably monitor their continuous compliance with regulatory capital requirements, it emphasises that this does not mean that firms need to recalculate the full SCR at all times.

While a full calculation of the SCR would be required should a firm's risk profile change significantly, continuous compliance can be assessed using a combination of calculation and estimation as appropriate based on an assessment of the volatility of both the capital requirements and the eligible own funds, and the level of solvency coverage that the company is operating at.

Despite this, many companies may need to make significant changes to their systems and processes in order to provide meaningful results for this requirement on a timely basis.

The assessment of the quantity and quality of own funds should consider as a minimum the mix between basic and ancillary own funds, the amount of own funds resulting from expected profits in future premiums (EPIFP), and the sensitivity of the regulatory compliance to increases in capital requirements or reductions in own funds.

The need to consider capital required to remain a going concern into the future differentiates the ORSA from the SCR. Any regular business plan developments should be reflected in the ORSA process and possible outcomes of the plan have to be tested. The frequency of the ORSA being updated will be influenced by changes to strategy and implementation. When assessing future own fund requirements, firms should ensure capital management is taken into account as well as the ability to raise further own funds of an appropriate quality and in an appropriate timescale. Any realistic actions which a firm may take to offset or compensate for the impact of future stress events on capital or cashflow positions should be identified and assessed as part of the ORSA process.

DEVIATIONS FROM ASSUMPTIONS UNDERLYING THE SCR CALCULATION

The ORSA process must include an assessment of the deviations between a firm's risk profile and the assumptions underlying the SCR calculation. In requiring this, the paper stresses that firms should not be relying purely on regulatory capital requirements as being adequate for their business. Where significant deviations exist, firms should look to address these by either working to align their risk profile more closely with the standard formula, by using undertaking-specific parameters, or by developing an full or partial internal model for the calculation of the SCR.

The paper provides guidelines for internal model users in terms of understanding how the internal model fits into the ORSA process (as part of the use test) and highlights that the ORSA should specifically address those risks that are not included within the internal model. Where the ORSA is used by firms to assess the effectiveness of the internal model, EIOPA has emphasised that there is no need to duplicate tasks associated with the annual assessment of the compliance of the internal model. The paper states that a major model change would be a situation which triggers the need for performing an updated ORSA.

GROUP REQUIREMENTS

While the majority of the guidelines apply to both solo firms and groups, a number of specific guidelines are provided for groups. In discussing the scope of the Group ORSA it is stressed that third country entities are an important part of this assessment. Unregulated entities are highlighted as being treated in a way which reflects their role within the group, thereby capturing all risks arising from such entities within the Group ORSA.

Regarding documentation for the Group ORSA, it is noted that group effects should be identified and the sum of solo SCRs should be compared to the Group SCR. In assessing overall group solvency needs, group-specific risks should be considered, and the paper lists examples of such risks that should be included.

For group internal model users, the paper provides guidance about the considerations which should be made in relation to the entities using or not using the group internal model and how the various risks of group entities are captured. There is also guidance about how to deal with risks which may not be significant for the group overall but which are material at the solo entity level. Helpfully, the paper also outlines options for preparing and reporting the ORSA on business unit lines rather than by legal entity.

SUMMARY

This consultation paper builds on the previous draft guidance set out in the pre-consultation paper released by CEIOPS in December 2010, focusing on the desired outcomes of the ORSA process rather than how the ORSA is to be performed. This should come as a welcome relief to many firms that have progressed in both the design and the development of their ORSA processes based on this previous text.

The paper reinforces the message that Solvency II is an outcome-based regime and that the supervisors are not solely going to be looking at "how" something is done, but rather more at what the "result" is.

The paper contains some useful guidance for firms using either the standard formula or an internal model for the calculation of their regulatory capital requirements and how the ORSA should link to, and support, this process. Furthermore, the additional insights for groups relating to the translation of particular requirements to take into account the extra dimensions of group requirements will be particularly helpful for many organisations.

Any comments on this consultation paper should be provided directly to EIOPA, using the template on its website, by 20 January 2012.

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CONTACT

If you have any questions or comments on this briefing paper or any other aspect of Solvency II, please contact any of the consultants below or your usual Milliman consultant.

William Coatesworth
william.coatesworth@milliman.com
+44 20 7847 1655

John McKenzie
john.mckenzie@milliman.com
+44 20 7847 1531