South African Insurance Association

Issue 3 / 2011

SAIA SAM PSO

Newsletter

ORSA: meeting the challenge and seeking the value

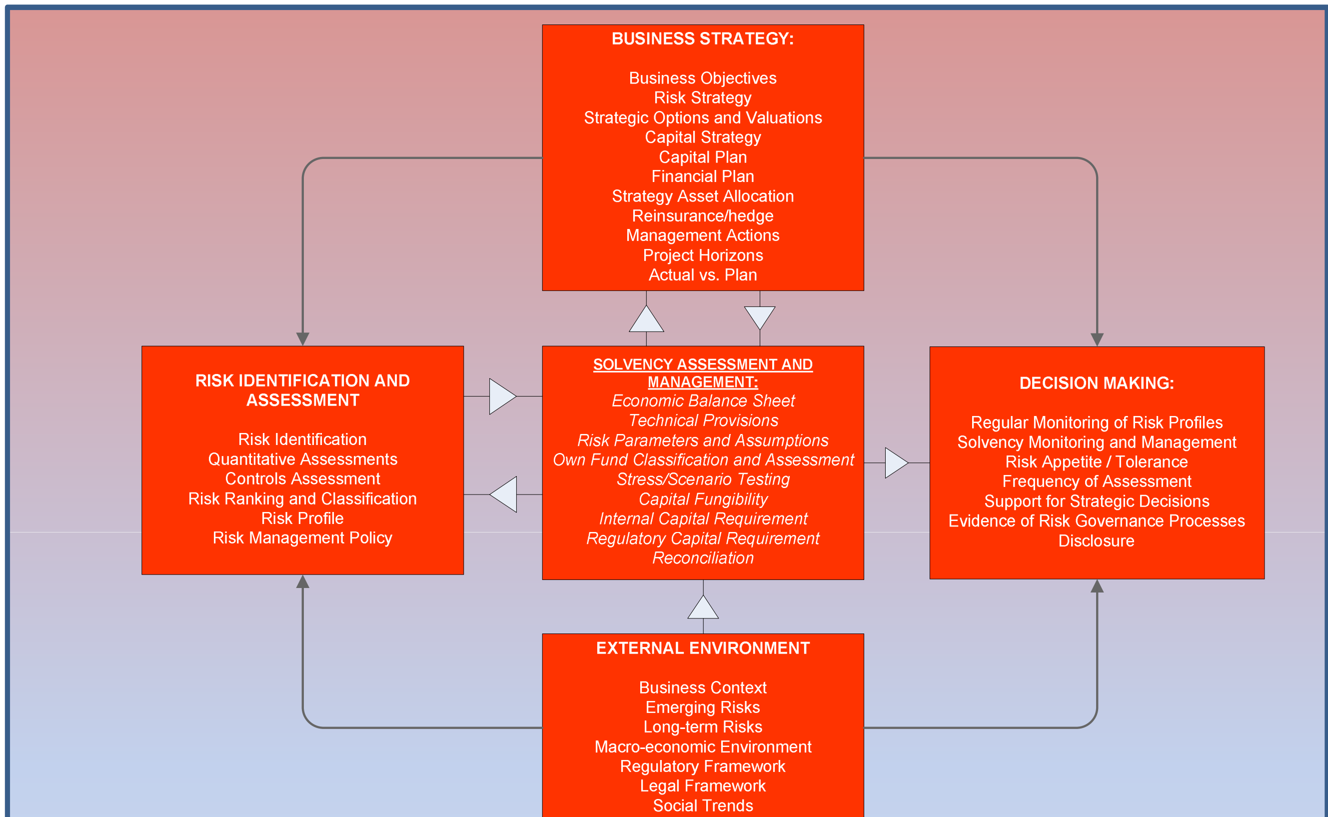
Insurers preparing for Solvency II are finding that meeting the requirements for the Own Risk and Solvency Assessment (ORSA) is proving to be the most important, and potentially the most valuable, aspect of the Solvency II project, says Chris Hancorn.

More than just a regulatory requirement, the ORSA has come to be seen as part of a continuous process and a key management tool that brings together many of the essential features of an enterprise-wide risk management framework. It cuts across all the key elements of risk and value management, including risk appetite, risk assessment, capital management and business strategy.

The ORSA aims to enable the board to monitor and manage its company's risks and determine its overall solvency needs. The assessment should take account of the company's risk appetite, risk profile and business strategy, covering both present and prospective risks. The prospective view required under the ORSA takes many firms beyond their normal capital allocation horizons, but it should align these more closely with the time frame over which the board makes strategic decisions. This will depend upon the nature of the risks the business is exposed to, but is typically considered to be around three to five years.

The ORSA also requires insurers to ensure continuous compliance with regulatory capital requirements. Not only does this mean making sure that the company is solvent today, but also solvent over their business planning period. This may require projections of capital requirements over that period, along with the expected level of own funds, to take into account risks that are reasonably likely to arise during this time frame.

As such, the ORSA goes beyond simply providing warnings lights for capital adequacy. It also helps senior management to understand how potential difficulties can be dealt with proactively. Stress and scenario testing will therefore be critical in helping to identify potential threats to the business and preparing plans to alleviate the worst of the impact and de-risk the balance sheet. In severe circumstances, stress and scenario analysis will enable companies to assess ways to recapitalise the business, or when all else fails, ensure an orderly run-off.



Taking ORSA beyond regulatory requirements: a key tool for the risk and capital management process. Source: PwC

Interactive process

The ORSA should be seen as a continuous assessment, and as an interactive process between the board and executive team. It focuses on the key areas of risk identification, capital planning against risk appetite, and will take into account scenario analysis, and how the results will impact on the Solvency Capital Requirement (SCR) and the board's own assessment of solvency needs.

The capital evaluations within the ORSA focus on what management itself believes the business will need, and are therefore quite distinct from the capital requirements set by the regulator. Indeed, regulatory and management assessments could differ quite markedly, particularly for firms using the standard formula to determine capital requirements. Supervisors will expect boards to consider how much capital they would like their company to hold in order to achieve the desired risk profile.

This assessment of an insurer's overall solvency needs is dependent on its understanding of its risk exposures and its appetite for them. It is therefore important that all firms can identify and quantify their exposures. For insurers with an approved internal model, this process will complement the regulatory capital assessment. Companies using the standard formula will also have to demonstrate how they are quantifying their risks and determining their overall solvency needs, as will firms using a partial internal model (where they calculate their SCR using the standard formula, they should still use their own methodology to quantify their solvency needs).

Firms that approach the ORSA as a management tool - rather than simply a regulatory assessment - will be more successful at integrating it into their business processes and unlocking the value. The potential benefits of a well-structured ORSA include the ability to respond proactively to a possible future change in their risk profile, which could affect their capital strategy. An effective ORSA can also provide useful insights into the capital efficiency of the business and management actions needed in the future. Indeed, the ORSA may reveal that the company is holding far more capital than it actually needs and could therefore deploy some of these funds more profitably elsewhere.

The ORSA will also enable companies to evaluate the long-term capital efficiency of particular products under the new Solvency II regime and assist in the design of new policies. Although the internal ORSA report will be more detailed than would be required for public disclosure and supervisory reporting under Pillar 3, elements could be adapted for these reports. The internal ORSA report could also provide a good basis for discussions with analysts and rating agencies.

As part of the principles-based approach that regulators are putting in place for the ORSA, the onus will be on insurers themselves to develop a viable ORSA process and make it work for their business. That gives the opportunity to insurers to get their ORSA framework right and reap the benefits that it brings in terms of sound risk and capital management.

The quantitative implementation challenges include developing approaches to scenario testing of current and projected economic balance sheets in order to inform stress tests. The testing will need to take into account strategy as well as the external environment. Consideration will need to be given as to how to build in risk appetite into the assessment and turn the resulting capital plan into a business-level plan, in addition to methods for solvency estimation.

Other more qualitative challenges include turning the output into timely and effective management information, which will allow the board to make appropriate and timely decisions and communicate effectively with supervisors, thus bringing the whole process together into an effective control cycle.
The key to successful implementation is to recognise what is already there, and build upon it, without duplicating the work of others.

Chris Hancorn is associate director in the risk advisory team at PwC

This article is from InsuranceERM.com available at:
http://www.insuranceerm.com/analysis/orsa-meeting-the-challenge-and-seeking-the-value.html

EIOPA

As the Soccer World Cup year drew to a close it took with it the keys to the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), locking the doors of this organisation for good and giving rise to the newly formed European Insurance and Occupational Pensions Authority (EIOPA).

The global financial crisis, amongst others, created an acute awareness for the need to protect and strengthen the European financial sector and to reduce any further risks faced by European firms due to future financial uncertainties in the market place. A Commission was established to provide a proposal for a new cross-border supervisory regime. The Commission presented the European Parliament and Council with proposals for a new regulatory framework that was approved on the 22nd September 2010 and became effective from the 1st January 2011.

The framework consists of the European Systemic Risk Board (ESRB) which comprises three European Authorities reporting to the ESRB. These Authorities are the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA).

The newly formed EIOPA is based in Frankfurt, Germany and has replaced CEIOPS as of the 1st January 2011. Supporting the stability of the financial system with specific regard to transparency of markets and financial products, protection of policyholders, pension scheme members and beneficiaries are the overriding objectives of EIOPA. Further to this EIOPA has also been mandated to identify and mitigate economic risks which could have

an impact on insurers.

EIOPA began its work on the 1st of January 2011 with a staff contingent of about 28 employees and intends to increase this number to around 50 experts by the end of 2011. The first management board of EIOPA has been elected and Mr Gabriel Bernardino, who was the former Chairman of CEIOPS, has been selected to be the first Chairperson of this new Authority.

Further details and information regarding EIOPA can be viewed on their website at https://eiopa.europa.eu

Omnibus II Directive

On the 19th January 2011 the European Commission published a draft proposal for a Directive known as the Omnibus II Directive. This directive will amend certain areas of the Solvency II Directive, if eventually adopted and accepted by the European Commission (Commission). The areas where amendments are mentioned which are of particular interest to insurers are those referring to transitional measures.

The Omnibus II Directive defines maximum transitional periods that the Commission might accept and adopt as well as the minimum requirements that will have to be complied with during the transitional period. All insurers that are subject to the scope of the Solvency II Directive will be affected by the proposed amendments as contained within the Omnibus II Directive, if adopted by the European Commission.

A few of the important areas where transitional measures are proposed are:

- The Solvency Capital Requirement (SCR), valuation of assets and liabilities, calculation of technical provisions and own funds - a transitional period of up to ten years is suggested
- Governance – a transitional period of up to three years
- The public Solvency Financial Condition Report (SFCR) and reporting to supervisors (RTS) - up to three years

- A transitional measure which would be of particular importance to South African is the issue of Equivalence. It is proposed that the European Commission may grant third country supervisors “equivalence” status for a period of up to 5 years, while countries adapt and implement a solvency regime that meets the equivalence criteria of Solvency II.

SAIA South African Insurance Association

Issue 3 / 2011

The transitional measures as proposed by the Omnibus II Directive are far reaching for European firms with the smaller insurers being able to gain the most from these measures. The larger more sophisticated organisations might feel that they would lose a potential competitive advantage, especially after all the work that they have completed to ensure that they are prepared for the Solvency II implementation deadline. The Omnibus II also formalized the postponement of implementation of Solvency II from 1 November 2012 to 1 January 2013.

It is important to note that the proposed Omnibus II Directive is still in its infant stage and receiving a great deal of comment and interest from insurers in the European Community (EU). The decision to allow transition measures to the Solvency II Directive has not been accept as yet, however given the advent of the current proposals it would suggest that insurers could probably expect transitional measures of some kind in the near future.

The Omnibus II Directive is not applicable to the South African environment at the moment but we are watching the developments with keen interest as these transitional measures will have a definite effect on all insurers' implementation plans.

Solvency II Snippets

- In a press statement issued on the 14th March 2011 EIOPA announced to the market that the results of QIS5 had been released. The press release specifically highlighted the fact that "*EIOPA had concluded that transitional measures are needed, particularly to ensure a smooth transition from Solvency I to Solvency II that would not disrupt ongoing business and would ensure continuous competitiveness of insurance companies*"

  "*The main lesson learned from the QIS5 is that a prudent framework has to be based upon sound capital requirements, with particular attention to the quality of capital.*"

  "Overall, QIS5 found that the financial position of the European insurance and reinsurance sector assessed against the solvency capital requirements of the Solvency II directive remains sound."

  The complete press release as well as the QIS5 report can be viewed on the EIOPA and the SAIA websites.

- The new head of EIOPA has promised a pragmatic response to the latest field test of Solvency II. In an interview held with Reuters on his first day in office, EIOPA chairman Gabriel Bernardino said that EIOPA would address the problems raised by QIS5, which has faced strong criticism over some of its calibrations, such as the treatment of catastrophe risk. "*That doesn't mean we need a major reshuffling," Bernardino told Reuters. "I can assure you that we will learn from QIS5. That's part of the process. But let's not over-react."*

  Bernardino also said that he did not expect Solvency II would lead to an industry-wide increase in capital levels. But he accepted that some insurers would need to increase capital and that they would be given time to do so. *"If, at the end of the day, no-one needs to have higher capital, then we might not have done our risk assessments correctly,"* Bernardino said. *"I am sure this [capital-raising] will be limited to specific situations. Overall, the industry is well capitalized."*

  He said that EIOPA would undertake a review of the standard model for calculating capital requirements under Solvency II, which has been criticized for disadvantaging smaller insurers.

- The FSA is to levy over £34m in fees against insurers in 2011/12 to cover the cost of implementing the Solvency II regime. The special project fees are in addition to the proposed annual funding requirement.

  The FSA said that its estimated budget for Solvency II implementation in 2011/12 was £46.4m. But owing to an under spend in 2010/11, mainly due to delays at an EU level, the budget for 2011/12 had been reduced to £34.4m. The special project fees aim to cover the cost of ***approving insurers' internal models*** in addition to other costs related to Solvency II.

  The FSA said the total cost of implementing Solvency II over the life time of the program remained within its forecast range of £100m to £150m.