Solvency II and ORSA
Agenda

**Background**
- The “Stick” – Compliance with ‘regulators’
  - Solvency II, ORSA
  - SMI, US ORSA
  - Rating agency expectations

**What’s in it for me – Why is this important to you?**
- The “Carrot” – Leading practice
  - Benefits to company
  - Structure
  - Uses
- ORSA specifics
The “Stick”

External forces
Regulators also need to comply with ‘regulation’!

- International Association of Insurance Supervisors’ need to follow Insurance Core Principles, Standards, Guidance, and Assessment Methodology (ICP).
  - Basis of Financial Sector Assessment Program by IMF and World Bank
  - ICPs
- Regulators will increasingly look at:
  - ICP 5: Suitability of Persons
  - ICP 7 Corporate Governance
  - ICP 8 Risk Management and Internal Controls
  - ICP 9 Supervisory Review and Reporting
  - ICP 16 Enterprise Risk Management for Solvency Purposes
Overview of Solvency II
The three pillar concept

Three pillars and a coherent economic framework

PILLAR I
Measurement of assets, liabilities and capital
- Balance Sheet evaluation
- Technical Provision
- Solvency Capital Requirement (SCR)
- Minimum Capital Requirement (MCR)
- Investment Rules

PILLAR II
Supervisory review process
- Corporate Governance & Internal Control
- Risk Management
- Supervisory Review Process
- Own Risk & Solvency Assessment (ORSA)

PILLAR III
Disclosure requirements
- Annual published solvency & financial condition report
- Information provided to the supervisors
- Link with IFRSs
Solvency II – Regulatory requirements framework

**Governance**
- Risk strategy and appetite
- Monitoring and management
- Reporting and MI

**Pillar I**
- Quantitative Measures
- Models and Validation
- Capital Requirements (SCR/MCR)

**Pillar II**
- Use test
- Own Risk and Solvency Assessment (ORSA)

**Pillar III**
- Disclosure

**Organization**
- Insurance risk
- Market risk
- Liquidity risk
- Credit risk
- Operational risk

**Outsourcing**
- Reinsurance

**Systems and data**
- Policies, standards and definitions

**Internal control**
Proposed regulations – Solvency Modernization Initiative

U.S. Reform: The Solvency Modernization Initiative

- The U.S. is forging ahead with the National Association of Insurance Commissioners’ (NAIC) Solvency Modernization Initiative (SMI).

- NAIC – SMI is a critical self-examination of the United States’ insurance solvency regulation framework and includes:
  - Review of international developments regarding insurance supervision
  - International accounting standards
  - Potential use in U.S. insurance regulation.

- SMI Task Force is expected to recommend areas of improvement for the U.S. solvency framework. As proposed, the SMI framework contemplates:
  - Review of Risk-based capital formula and consideration of more advanced methods such as ECM
  - Group solvency regulation
  - US ORSA hopes for requirement to be in place January 1, 2015
  - Corporate governance
  - Risk management
  - Statutory accounting and financial reporting and reinsurance.
Rating agencies are outlining increasingly stringent risk management requirements for insurers and moving towards becoming the de facto industry benchmark.

<table>
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<tr>
<th>Area of focus</th>
<th>Observation</th>
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| Risk management culture        | - Transparency  
                              - Risk tolerances are standardized and used for measuring effectiveness of actions taken                                                   |
| Risk controls                  | - Risk tolerances are defined and managed  
                              - Specific limits are set and are consistent company-wide  
                              - Exposure is managed consistently                                                                           |
| Emerging risk management       | - Proactive  
                              - Variance tolerances managed                                                                                      |
| Risk and economic capital models | - Evaluating risk and return of strategic objectives  
                              - Manage to optimize risk/reward  
                              - Models are accurate and timely, robust and comprehensive  
                              - Complexity of model more directly reflects complexity of risk  
                              - Actionable information                                                                                            |
| Strategic risk management      | - Systematic and consistent  
                              - Considers external as well as internal perspectives on risk  
                              - Risk appetite and profile are continuously updated  
                              - Changes to profile or strategic plans are communicated  
                              - Diversification of risks and risk correlations                                                              |
Summary of external influences

New Standards of ERM Leading Practice

- Solvency II
- NAIC ORSA and SMI
- NAIC Risk-Based Exams, etc.
- ASB Draft ERM ASOPs
- Financial Crisis Experiences
- FIO/Dodd-Frank
- Rating Agency Standards
- IAIS ICP and FSAP
The “Carrot”
What is in it for you?
ERM = Enterprise Risk Management (ERM)

What is ERM?

The International Association of Insurance Supervisors defines ERM as: “A process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives”.

Risk Management requirements in ICPs and Solvency II – overlap with ERM concepts
ERM is important to business success

- Strategy and Goal: Where is your business headed?
- Governance: Who is responsible?
- Risk Identification and Quantification: What are the risks in meeting that goal?
- Risk Analysis, Mitigation: What are you going to do about it?

Make Compliance provide Returns to your Business!
Driving commercial benefits from risk management

Adequate risk capability to focus on the **right things at the right time** i.e., material risks, areas of volatility to minimize costs and reduce losses

Remove duplication and increase consistency in processes and controls

**Integrate** risk and business management resulting in **increased awareness** of emerging risks, the changing external environment and what this means for the business

**Strong accountability at each level** across the business promoted by a **compelling tone from the top**

**Improving business results** through realizing suitable opportunities and allocating capital in a **risk-aware manner**
Risk management needs to cover all aspects
What is risk appetite?

Risk appetite can be defined as:

“An expression of the level of risk the group is willing and able to accept in pursuit of its strategic objectives.” (KPMG)

RISK APPETITE FRAMEWORK

**Corporate Strategy:**
Corporate strategy outlines the goals and strategies of the organization.

1. **Statements:**
   Translate the corporate strategy into explicit statements of risk.

2. **Measures:**
   Quantitative and qualitative metrics that can be used to articulate the statement.

3. **Limit Framework:**
   Determines the limits or thresholds against the measures.

4. **Governance:**
   States the roles and responsibilities of individuals charged with delivering risk appetite.
Why do you need a risk appetite framework?

- **Protect earnings and the balance sheet**
  - Develops a top-down framework that increases board oversight
  - Enables the board to allocate risk-taking mandate
  - Embeds risk management into the first line of defense

- **Enhance risk-reward profile**
  - Better linking of risk to business decisions and clarity of acceptable risks that can be taken
  - Assist in identifying inconsistencies and opportunities in risk profile

- **Encourage consistent behavior**
  - Aligning day-to-day business decisions to the strategy and objectives of the business
  - Speeding up decision making through clarity of decision making, delegated authorities, and escalation criteria

- **Meet regulatory and external expectations**
  - Regulatory requirements of the Solvency II Directive
  - Solvency II Use Test requirements
  - Rating agencies’ assessments
A risk management function should:

- Comprise **strategies, policies,** and **processes** to identify, measure, monitor, manage, and report risks, including interdependencies between risks.

- Facilitate the implementation of the risk management systems for:
  - Underwriting and reserving
  - Asset – liability management
  - Investments (credit and market risks)
  - Liquidity and concentration risks
  - Operational risk
  - Reinsurance and other risk mitigation techniques
System of governance

Some risks are better addressed by governance requirements and not just by setting quantitative requirements

Board has ultimate responsibility for compliance (Art 40)

Requirements of a system of governance (Art 41)

Adequate and transparent organizational structure

Clearly articulated segregation of responsibilities

Effective system for reporting of information

Should be proportionate to nature, scale, and complexity of operations

Written policies regarding all aspects of governance

- Board approved and reviewed at least annually

Comply with Articles 42 to 48
System of governance – Summary

- Capital management
- Fit and proper
- Risk management
- Internal control (Compliance)
- Internal audit
- Actuarial
- Outsourcing
- ORSA

Complying will demonstrate the “embeddedness” of the governance system group wide via active board and senior management involvement.
Potential uses – Lots!

Adequate pricing
Assessing customer benefits, for example, bonus setting
Asset/liability management
Business planning/strategy
Capital management
Development and monitoring of risk appetite
Development of risk strategies
Efficient use of capital
Exposure management and limit setting
External risk reporting
Financial reporting – internal model provides market valuations for IFRS
Incentive/target setting
Internal risk monitoring (through MI)
Investment decisions, e.g., strategic, tactical, and operational decisions
M&A
Measurement of material risks
ORSA
Other risk mitigation
Portfolio transfer pricing
Producing MI

- Product development/pricing
- Reconciliation between internal model outputs and internal and external financial reporting
- Reconciliation between internal model and the technical implementation of management actions, e.g., for with-profit business
- Reconciliation between internal model and technical provisions
- Regulatory capital (SCR for solo and for groups)
- Reinsurance decisions, e.g., strategic
- Reinsurance program design
- Reinsurance strategy and development of reinsurance program
- Reporting on MCEV/EV
- Reporting on business performance
- Reporting on performance including return on capital
- Reporting on technical provisions
- Risk balancing (efficient use of capital)
- Risk mitigation
- Setting profit targets
- Setting return on capital targets and remuneration
- Underwriting policies
Definition of ORSA

CEIOPS Issues paper May 27, 2008 defines the ORSA

“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” vs. “ORSA outcome”

More than a just a calculation engine!

Proportionality principle
ORSA – The regulations and what they mean

Level 3 pre-consultation

- Despite the call for further detail, in the Level 3 paper CEIOPS has maintained its position of insisting that principles, not detailed guidance, are provided—practical implementation challenge remains...
- CEIOPS has provided 29 guidelines with supporting material in the Level 3 paper

“The main purpose of the ORSA is to ensure that the undertaking engages in the process of assessing all the risks inherent in its business and determines its corresponding capital needs.”

“These guidelines focus on what is to be achieved by the ORSA rather than on how it is to be performed.”

“The ORSA is not complied with by just producing a report or by filling templates.”

“Conducting an assessment of the overall solvency needs properly involves input from across the whole undertaking.”
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

<table>
<thead>
<tr>
<th>Principle</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>Principle A</strong></td>
<td>The ORSA is the <em>responsibility of the undertaking</em> and should be <em>regularly reviewed</em> and <em>approved</em> by the undertaking’s administrative or management body.</td>
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<tr>
<td><strong>Principle B</strong></td>
<td>The ORSA should encompass <em>the material risks</em> that may have an impact on the undertaking’s ability to meet its obligations under insurance contracts.</td>
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<tr>
<td><strong>Principle C</strong></td>
<td>The ORSA should be based on <em>adequate measurement and assessment</em> processes and form an <em>integral part of the management process and decision making</em> framework of the undertaking.</td>
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<tr>
<td><strong>Principle D</strong></td>
<td>The ORSA should be <em>forward-looking</em>, taking into account the undertaking’s business plans and projections.</td>
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<tr>
<td><strong>Principle E</strong></td>
<td>The ORSA process and outcome should be <em>appropriately evidenced</em> and <em>internally documented</em> as well as <em>independently assessed</em>.</td>
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</table>
ORSA – The business tool

Assesses whether a firm’s risk management and solvency position is and will be adequate

Demonstrates to regulators and rating agencies the robustness of a firm’s risk and capital management framework

Enhances decision-making through assessments of the impact on the firm’s risk profile and solvency positions

Promotes an integrated approach to managing all risk exposures aids the assessment, management and understanding of risk

Board Responsibility
Key actions

- Establish risk management with risk appetite and tolerances
- Embed within strategic decision making

Processes

- Identify stakeholders
- Clarify roles and responsibilities

Governance

- Identify ERM data requirements
- Compare requirements to existing internal processes
- Understand enhancement of current MI to support the enhanced ERM process

Gap analysis
### Some observations

#### Common pitfalls to avoid

1. Documentation too difficult to digest – doesn’t evidence the assessment
2. Late involvement of senior management and board
3. Overly focused on quantitative areas and the report
4. Fragmented approach adopted – no link between risk, capital, strategy, etc.
5. Poor independent challenge
6. Stress testing:
   - Inappropriate scenarios used
   - Stressing focused on one risk
   - Interdependencies/linkages not taken into account
   - Unrealistic management actions
7. Not implemented consistently group wide
8. Not “driven” from the top-down
Thank you

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