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Winning over key stakeholders: The Own Risk and Solvency Assessment

The Own Risk and Solvency Assessment (ORSA) is an opportunity to showcase the firm's risk management capabilities and demonstrate how risk and capital management is used to support decision making and ultimately create value. Farid Bonawiede, Erica Nicholson and Immy Pandor examine why the ORSA is set to be such an important regulatory mechanism under the new regime and how it will provide firms with an opportunity to extract real business value from their Solvency II investment.



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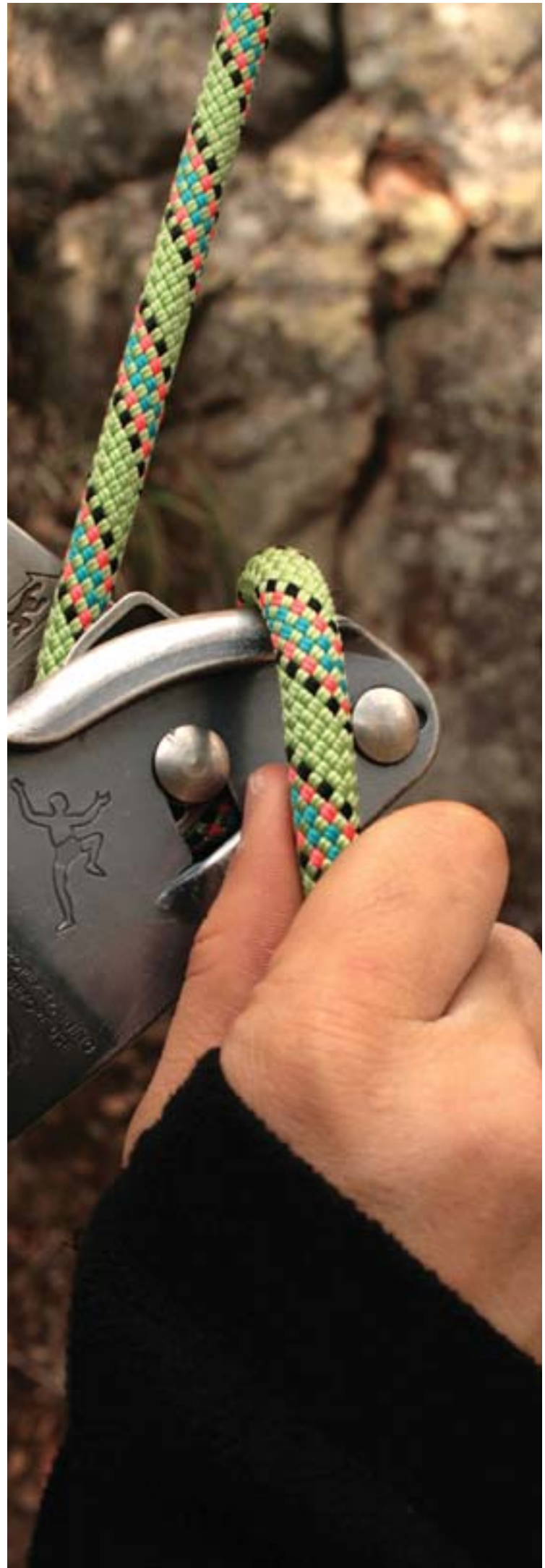
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The ORSA only occupies a few lines in the Solvency II Framework Directive (Article 44). Yet the ORSA process is set to be a key driver for embedding enterprise risk management (ERM) into the business and the resulting reports are likely to be one of the most important aspects of supervisory review under the new regime.

According to the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), a key adviser to the European Commission on the implementation of Solvency II, the ORSA 'aims at enhancing awareness of the interrelationships between the risks an undertaking is currently exposed to, or may face in the long term, and the internal capital needs that follow from this risk exposure'.¹ As a 'management tool', it is designed to instil risk awareness in the culture and decision making of the company, forming 'an integral part of the overall business strategy' and helping the firm to 'obtain a real and practical understanding of the risks it is assuming'.²

Companies' assessments should ensure that they can 'continuously meet the regulatory capital requirements, as well as the internal capital targets they set themselves'³ in the face of changes in their risk profile and business plans, as well as the impact of developments in the external environment. The ORSA should include a 'forward-looking perspective' through a combination of risk, capital and solvency projections and, stress and scenario testing, and help create contingency and mitigation plans that set out the firm's options for managing and maintaining its capital and solvency position in line with its desired risk appetite. The required scope, frequency and detail of these evaluations are likely to be extensive in the wake of the financial crisis.

Ultimate responsibility rests with the Board, with all the components of the ORSA to be captured in a report signed off by the 'administrative body' and presented to supervisors for review. The financial crisis has raised questions about some executives' appreciation of the nature and extent of the risks being assumed by their frontline teams. From a supervisory perspective, the ORSA will therefore play an important role in ensuring that the Board maintains appropriate understanding and oversight of the entity's risk exposures. From the company's perspective, the ORSA can provide senior management with the information and assurance it needs to strike a sustainable balance between risk and reward and, not least, to avoid damaging surprises.

Showcase for ERM

Solvency II is set to provide further impetus for the development of ERM by requiring insurers to create a competent firm-wide risk management framework and integrate this into their governance and business planning processes. Companies are also facing regulatory pressure to ensure that their remuneration policies are consistent with sound risk management. Organisations with effective ERM capabilities and a strong culture of risk awareness will find it much easier to demonstrate the necessary risk understanding and control through the ORSA process. This assurance should enhance regulatory confidence and reduce the level of scrutiny and potential for any additional capital to be applied by supervisors.

If minimum Solvency II compliance is the first hurdle, rating agencies are setting a higher bar, which encourages insurers to manage risk and capital in a way that enhances the quality of earnings. This includes helping to

sharpen balance sheet management and optimise the risk/reward profile in areas ranging from product design and pricing through to actively managing the firm's in-force portfolio. According to AM Best, 'an insurer that can demonstrate strong risk management practices integrated into its core operating processes, and effectively execute its business plan, will maintain favourable ratings in an increasingly dynamic operating environment'.⁴

By pulling together the risk appetite, risk-based capital requirements and overall business strategy, a robust ORSA report offers a compelling basis to communicate the strength of the company's solvency position and the embedding of ERM in the organisation. Key aspects of the report could be shared with rating agencies, along with other stakeholders such as joint venture partners. A well-prepared ORSA will be particularly beneficial in enabling firms to demonstrate how ERM supports capital efficiency, the management of emerging risks and the articulation/application of the risk appetite within the organisation, aspects of management which now form a critical part of rating agency financial strength evaluations. The ORSA report can also help to facilitate broader discussions in areas such as business development, the thinking behind risk management and response to possible future scenarios.

1, 2, 3 'Own Risk and Solvency Assessment', issues paper published by CEIOPS on 27.05.08.

4 'Risk management and the rating process for insurance companies', published by AM Best on 25.01.08.

Figure 1: A best in class ORSA report can be expected to cover a number of specific items

<p>1. The ORSA report process A description of the governance (challenge, discussion and debate) process surrounding the submission of the report</p>	<p>5. Risk appetite The firm's risk appetite statement, process for managing within desired parameters and the firm's current profile</p>	<p>9. Stress and scenario testing The firm's future capital/solvency position under a number of reasonably plausible (downside) stress tests and scenarios</p>
<p>2. Context and scene setting A summary of the firm's legal and management structure, its core business and the market environment in which it operates</p>	<p>6. Risk identification and assessment An overview of the firm's processes and procedures for identifying, assessing and prioritising its key risks</p>	<p>10. Capital plan The firm's capital plan under the base case and under downside stress tests and scenarios</p>
<p>3. Risk management philosophy An outline of the firm's risk management philosophy (i.e. how the risk dimension is used in the business)</p>	<p>7. Point-in-time capital and solvency position The firm's point-in-time capital and solvency position along regulatory and economic dimensions</p>	<p>11. Use test An overview of how the firm's risk and capital management activities are fully integrated into the management process and operations</p>
<p>4. Risk governance An outline of the firm's risk governance, risk control processes, procedures and policies</p>	<p>8. Forecast capital and solvency position The firm's projected capital and solvency position over the plan period (3 to 5 year outlook)</p>	<p>12. Ad-hoc ORSA re-runs Formal presentation of ad-hoc 'event driven' risk, capital and solvency assessments during the reporting period</p>

Although much of the ORSA will be confidential between the firm and its supervisor and probably more detailed than would be required under Pillar 3 market disclosure, elements could be adapted for the required solvency and financial condition reports (see article on pages 18–23). At a time when capital is severely constrained, the results of the ORSA report could help to send a clear and credible message to the markets that this is a firm that can target capital efficiently and react quickly and decisively to opportunities, while operating within strict and well-informed risk tolerances. Enhanced market confidence can, in turn, increase the capital-raising potential as and when required.

Practical implementation

The key aims of an effective ORSA are now reasonably clear – an ongoing 'business as usual' process through which the Board and the regulator is kept apprised of the firm's current and future

anticipated risk, capital and solvency position and is provided with the means to assess the efficacy of its risk management framework. However, there is less certainty about the detailed application. While further implementation guidance may be forthcoming following the strong call made by insurers for greater clarity, we do not anticipate Level 2 implementation measures or Level 3 national legislation to be detailed and/or prescriptive as this will detract from the process being a firm's own assessment of its risks and solvency. Consequently, insurers will still have a considerable amount of discretion in what is a principles-based process.

Based on our work with clients and discussions with regulators and rating agencies, Figure 1 outlines what we believe will be the key components of the ORSA report. The precise focus and level of detail will need to be tailored to the specific characteristics of the business and be proportionate to its scale, nature and complexity.

Given the comprehensive nature of the ORSA report it is important that firms begin to define their ambition for the ORSA process if they have not done so already. This includes the scope of the evaluations, what will be reported and who are the key recipients. It is also important to assess their state of readiness, identify any material gaps that will need to be filled and carry out the cost/benefit analysis before embarking on the ORSA journey. Firms which have not developed sophisticated ERM and related risk-modelling capabilities may wish to confine their ORSA to demonstrating the competence of their risk management and alignment with business planning needed for minimum Solvency II compliance. Companies with a more developed framework may naturally want to secure some of the payback from their investment by using their ORSA to display their strengths and enhance stakeholder confidence.



Firms should seek to explain their risk management philosophy, including how risk considerations affect strategic decisions; the metrics used to measure risk and reward and how capital management is aligned to risk-bearing capacity. The risk appetite defines how this philosophy is applied within the business. It is therefore important to show how the risk appetite is translated into underwriting limits and is supported by appropriate monitoring and enforcement.

The capital plan should include a forecast of how any anticipated changes in the underwriting strategy and/or risk profile would affect the solvency position and a projection of the impact and response to a range of possible stresses and scenarios. Although the assessment itself does not have to be continuous, the ORSA should be updated regularly enough to ensure that compliance with solvency requirements is continuous. A company should also be ready to assess its risk, capital and solvency position 'without any delay' following a significant change to its risk profile.⁵ Triggers for updating the ORSA might include an acquisition, a new product launch or significant market events.

Validation is clearly critical. This includes checking the rationale for key assumptions against actual outcomes, and explaining the thinking behind any subsequent adjustments. The risk management framework and its operation should also be regularly reviewed by internal audit. In addition, it may be useful to benchmark the ORSA against peers and evolving best practice.

To demonstrate the integration of ERM into decision making it is important to tie the assessment and its results to the allocation of capital within the business. A further indication that risk awareness is genuinely embedded into the business is the alignment of performance objectives and related incentives to risk-adjusted measures.

What this comes down to is ensuring that the ERM programme is working as intended and that risk considerations genuinely influence key decisions. Companies with effective ERM programmes are likely to have most of the necessary systems and procedures in place. The additional challenge presented by the ORSA is ensuring that these are operated in a systematic, consistent and forward-looking way and underpinned by appropriate governance, validation and documentation. This could be quite onerous, and experience of comparable risk and capital assessments under Basel II suggests that firms should begin preparing now if they have not already done so.

The suggested format for the Basel II Internal Capital Adequacy Assessment Process (ICAAP) documents in the UK provides a useful benchmark for the presentation of the ORSA report. It is notable that while the Financial Services Authority (FSA) accepts that 'the ICAAP may be based on existing internal documentation, the FSA will clearly find it helpful to have a bespoke summary prepared to communicate the key results and issues to it at a senior level'. The FSA's guidance notes on the ICAAP states that the ICAAP report should be in a 'format that can be easily understood at a high level and contain all the relevant information that is necessary for the firm and FSA to make an informed judgement and decision as to the appropriate capital level and risk management approach'. Above all, this is a management tool rather than a technical risk report. 'Where appropriate, technical information on risk measurement methodologies, capital models and all other works carried out to validate the approach (e.g. Board papers and minutes, internal or external reviews) could be contained in appendixes'.⁶

Our experience of working with banks and supervisors in relation to the ICAAP has underlined its importance in

effectively demonstrating compliance with Pillar 2 requirements. It is also particularly useful in helping non-executive directors to understand the ERM process and communicate this to regulators. We would expect the ORSA to serve similar functions.

Up to scratch

By requiring companies to develop a holistic view of their risk profile and understand how risks affect their future solvency position, the ORSA can provide a useful aid to effective management. Firms would not only be prepared for the worst, but also better equipped to capitalise on opportunities than less well-informed and well-managed competitors. Companies will also be able to convey the strength of their risk control, the depth of their risk understanding and the efficiency of their capital management to key stakeholders. Although developing the necessary structures may be time-consuming, there is no need to create an additional layer of bureaucracy and compliance. The benefits of the ORSA can best be realised by embedding it into existing business processes and creating a report that is intelligible and meaningful for executives, rating agencies and other stakeholder groups. Indeed, many of the larger insurance groups have already invested heavily to develop their risk management capabilities. The risk dimension has formally been elevated to become a Board level topic with the equivalent of an ORSA being a regular standing agenda item. Solvency II will ensure that the rest of the insurance industry catches up.

⁵ 'Own Risk and Solvency Assessment', issues paper published by CEIOPS on 27.05.08.

⁶ 'ICAAP submission – suggested format', updated version published by the UK FSA on 22.11.07.

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