LLOYD'S

OWN RISK AND SOLVENCY ASSESSMENT (ORSA)

GUIDANCE NOTES

DECEMBER 2015

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INTRODUCTION

Background

All managing agents are required to submit an Own Risk & Solvency Assessment (ORSA) report(s) covering each syndicate under management on an annual basis. In 2016, the due date for submission is 31 March. Lloyd's does not expect the submission timing to change significantly in future years.

ORSA report development

Managing agents were first required to submit an ORSA report to Lloyd's at the end of 2011. Since then Lloyd's has seen significant development in ORSA reports as managing agents have continued to work to ensure that they are useful documents for the board and senior management, as well as ensuring that the content is sufficient to meet Solvency II requirements.

ORSA guidance

Final guidelines on the ORSA were published by the European Insurance and Occupational Pensions Authority (EIOPA) in January 2015 ('Final Report on Public Consultation No. 14/017 on Guidelines on own risk and solvency assessment' EIOPA-BoS-14/259).

Lloyd's requirements regarding the ORSA are set out in the Risk Management Minimum Standards and these are supported by guidance issued in 2011 and 2012, available via the links below.

Link to Risk Management Minimum Standards

Link to Lloyd's September 2011 and May 2012 ORSA guidance notes

In June 2015, the Prudential Regulatory Authority (PRA) issued a letter providing firms with feedback on the PRA's review of firms' ORSAs submitted in 2014 and 2015. This highlighted stress and scenario testing and the forward looking assessment as areas where the reports were noticeably weaker. The PRA's letter can be found at the link below.

Link to PRA ORSA feedback letter June 2015

2016 ORSA submissions

As in previous years, the ORSA report submitted in March 2016 must have been approved by the board in the previous 6 months. Therefore some managing agents may have planned and/or prepared their March 2016 submission prior to this guidance being issued. Where this is the case, we do not expect managing agents to revisit their ORSA report prior to submission to take account of this guidance. However, where managing agents consider that the guidance has implications for the next iteration of their ORSA report they should engage with their usual contact in Lloyd's Risk Management and Governance Oversight team to discuss this.

The ORSA report should be submitted to ORSAsubmissions@lloyds.com.

Purpose and Scope

This document provides additional practical guidance to support managing agents in the further development of ORSA frameworks with a focus on the ORSA report. This includes common areas that have been identified by the PRA's themed review work, our observations from 2015 ORSA report reviews and follow up discussions with managing agents.

The detailed guidance covers the following areas:

- Board sign off and embedding

- Business strategy
- Risks
- Capital and solvency
- Stress and scenario testing, including reverse stress tests
- ORSA record

The guidance focuses on the content of the ORSA report, as this is the output that is provided to Lloyd's. However, it is important that managing agents consider the implications of the areas discussed below in the context of their overall ORSA process.

GUIDANCE FOR SYNDICATE ORSAS

This section provides further guidance on a number of specific areas and should be read in conjunction with existing Solvency II requirements and guidelines, as well as Lloyd's Minimum Standards and supporting guidance.

Board sign off and embedding

The ORSA report that is submitted to Lloyd's must be board approved. This is a requirement of Lloyd's Governance Minimum Standards (GOV 3.7) and the guidance for GOV 3.7 sets out Lloyd's expectations in more detail. Lloyd's recognises that the level of full board discussion and challenge of the report will vary from managing agent to managing agent, dependent on the overall governance process for the ORSA report.

During Lloyd's ORSA report discussions with managing agents in 2015, a common theme raised by managing agents concerned the length of the ORSA report and plans that they have to streamline the ORSA report to enable the board to focus on key information. Managing agents need to continue to ensure that the report can be read as a standalone document; however, this does not mean that it must describe the ORSA process in detail. The ORSA process should be described in the ORSA policy and the report should make reference to this. Where there has been a significant change in the approach to any particular aspect of the ORSA process during the course of the year, Lloyd's would expect this to be highlighted in the ORSA report, along with the outcomes and conclusions of the assessment.

A number of managing agents have introduced a quarterly ORSA report; these are generally shorter than the annual ORSA report and will not necessarily cover all aspects that are included in the annual report. For example, reverse stress tests are commonly considered on an annual basis only and will not necessarily require a quarterly update. Quarterly reports that Lloyd's has seen in use are designed to inform the board on the ongoing risk assessment (i.e. SCR calculation, risks and monitoring risk appetite statements) and typically include charts and tables. Contents also usually include any ad hoc analysis performed during the quarter (e.g. new stress and scenario tests, new investment strategy etc.).This approach can help with embedding by introducing an explicit link between regular risk, capital and solvency reporting in the quarterly ORSA report and the annual ORSA report that must be submitted to Lloyd's. A common approach that Lloyd's has seen used by managing agents is to prepare three quarterly ORSA reports during the year, with the fourth being the more detailed annual report. Where this approach is adopted, the quarterly and annual ORSA reporting forms an important element of risk reporting to the board. Whilst the quarterly ORSA report has been introduced by a number of managing agents, this is not mandatory, but it remains important to ensure that there is adequate reporting on risk matters to relevant governance forums within managing agents.

Business strategy

The ORSA report should set out the medium term business strategy of the syndicate. Typically, this will cover the next 3 to 5 years, in line with the business planning horizon adopted by the business. It should set out the overall direction of the business in the medium term, covering aspects such as expansion into new products or geographic areas and acquisition of new books of business. Lloyd's does not expect managing agents to produce a detailed forecast of their SBF within the ORSA report, but should include some quantitative information on future plans to achieve the desired strategy, e.g. a breakdown by high level class of business and high level P&L, as well as the high level assumptions underlying the plans.

Managing agents will likely consider a number of alternative strategies during the course of their annual business planning process. Lloyd's does not expect the ORSA report to include information on all the alternative strategies that may have been considered and discounted as part of the planning process. However, possible variations to strategy should be considered as part of the stress tests around the future plans, e.g. alternative growth strategies (see the stress and scenario testing section below).

It is important that the ORSA report clearly sets out the business strategy and this should be linked to the other sections of the report, in particular the forward looking assessment of risks and solvency and the stress and scenario tests.

Risks

The ORSA report should include a summary of current material risk exposures at syndicate level, with emphasis placed on those key risk exposures approaching or outside risk appetite thresholds. Materiality can be considered by reference to those risks that consume the most capital. As well as information on the current risk profile compared with risk appetite statements and tolerance, the report should include historical information, e.g. comparison with the previous three quarters. The report should comment on specific mitigating controls or actions taken and where there are breaches of risk appetite, details of lessons learned and what has been done to mitigate recurrence of the same breaches should be included. Where managing agents adopt a quarterly ORSA reporting approach, they should ensure that the annual report includes sufficient information on changes and actions over the course of the year.

Managing agents should ensure that the ORSA report also covers the prospective view of the risks facing the business i.e. the key risks to the medium term business strategy. The assessment should take account of any relevant emerging risks and the impact that they may have on strategy and risk appetite.

The assessment of emerging risks was a common area of feedback from Lloyd’s review of ORSA report submissions in 2015. A number of reports referred to the emerging risk process but did not comment on the current emerging risks or any actions being taken in response. Lloyd’s expects ORSA reports to include information on the current emerging risks that a managing agent considers most relevant to its own circumstances and strategy along with details of any actions being taken to mitigate the perceived emerging risks. Managing agents should also take account of the emerging risks identified as part of their stress and scenario testing.

Capital and solvency

Managing agents should include their ‘own view’ of economic capital in the ORSA report, with supporting rationale to explain why it is considered appropriate. Even where managing agents use the ‘to ultimate’ SCR plus 35% uplift as their economic capital measure, they should be able to justify the rationale for their own assessment and why they consider this to be appropriate for the business. One way to approach this is to provide a high level explanation of what risks or issues the managing agent considers to be covered by the 35% uplift that are not otherwise covered by the internal model to ultimate SCR e.g. by reference to the results of stress and scenario tests and the future assessment of risks.

SCR analysis should be provided on both a ‘one year’ and ‘to ultimate’ basis. The most recent standard formula results should be included along with a comparison of the assumptions underlying the standard formula and the internal model SCR on a one year basis.

ORSA reports should include a projection of future capital requirements and comparison with expected own funds over the planning horizon, and should detail the assumptions underlying the projections. Lloyd’s recognises that the nature and make up of available funds will differ considerably according to the structure of individual syndicates. For example, managing agents may have limited transparency over available capital where this is provided by third parties. Where this is the case, managing agents should reference this within the

ORSA report and note potential actions/contingency plans where available capital is likely to be insufficient to support future business plans or under stressed conditions.

Where a managing agent is part of a larger group, there may be an expectation that the group will capitalise should additional funds be required. The ORSA report should provide some details to support that view, e.g. any undertakings provided by the group in relation to future business plans, high level details of the group's financial strength etc. Where there is a reliance on group support, Lloyd's would encourage managing agents to consider the implications of scenarios where stressed conditions would also affect the group.

Stress and scenario testing

Lloyd's has seen significant development in the stress and scenario testing aspects of ORSA reports as managing agents have continued to refine their approaches over the course of a number of ORSA report submissions. Observations on stress and scenario testing, including reverse stress tests, continued to be a common area of feedback from Lloyd's 2015 ORSA report reviews. The need to continue to improve this aspect of the ORSA report has also been a theme of PRA comments and feedback.

Stress and scenario testing should help to identify, analyse and manage risks in the business and as such should be an important element of managing agents' planning and risk management processes. The tests should be drawn from perceived and actual material risks to the business. The stress and scenario testing framework should include the following elements:

- *Stress tests* – generally assessing the impact of a change in a single risk factor.
- *Sensitivity tests* – analysis of the key sensitivities in the model.
- *Scenario tests* – assessing the impact of a change in the overall operating environment resulting from a range of factors or 'shocks' (e.g. relevant Lloyd's Realistic Disaster Scenarios).
- *Reverse stress tests* – assess scenarios and circumstances that would render the business model unviable, thereby identifying potential business vulnerabilities. The business model is described as being unviable at the point when crystallising risks cause the market to lose confidence in the syndicate/ managing agent, which will not necessarily be at the point that the business runs out of capital entirely.

The ORSA report should include information on the results of all the above elements. Where these items are covered in an appendix to the report it is important to ensure that the main body of the report includes conclusions from the tests performed, detailing key outcomes and the impact on solvency. Any actions identified as a result of the stress and scenario testing exercise should also be highlighted in the report.

As part of the ORSA, a range of stress and scenario tests of the medium term business strategy should be considered. These should focus on plausible scenarios, relevant to the specific syndicate and linked to the key risks described in the ORSA report. A common approach to stress testing the forward looking assessment is to consider the base case scenario over the medium term business planning horizon (typically 3-5 years), and best case/worst case scenarios for the planning period. Managing agents should ensure that their scenarios are consistent with the future business strategy described in the ORSA report, for example if the future strategy is to expand into a specific new class of business this should be reflected in the forward looking projections. The scenarios around the base case plan should consider the impact of market conditions and other relevant external events, as well as relevant emerging risks. Where the scenario assumes an event in the first year, consideration should be given to how this will impact subsequent years.

Stress and scenario testing is one of the areas covered in Lloyd's May 2012 ORSA guidance. On reverse stress testing, Lloyd's has carried out some analysis of the approaches seen across the market based on 2015 ORSA report submissions and further information on this is included in the Appendix. This is intended to provide a summary of the approaches taken in order to share good practice and highlight common areas for further development.

ORSA record

Guideline 3 of EIOPA’s final guidelines on the ORSA sets out the documentation that firms should produce for the ORSA, as follows:

- the policy for the ORSA
- record of each ORSA
- an internal report on each ORSA
- a supervisory report of the ORSA

Guideline 5, Record of each ORSA, states that firms should evidence and record each ORSA process and its outcome.

Since Lloyd’s previous ORSA guidance was issued there has been some debate as to whether the ‘ORSA Record’ should be a separate document, in addition to the ORSA report. However, Lloyd’s view is that the content of managing agents’ ORSA reports, combined with other supporting documents such as board minutes, Risk Committee minutes and quarterly ORSA reports, should already cover the requirements of an ORSA record. The aspect that may need further development is ensuring that the outcome of the ORSA is reflected in the report. A practical way of achieving this would be to update the report with the conclusions of the assessment, challenges provided, decisions taken and management actions agreed following board discussion and approval of the report. This updated version should then be submitted to Lloyd’s and, where required, the PRA.

The EIOPA guidelines allow for an internal ORSA report as well as a supervisory report. It remains Lloyd’s preference that the board should receive and use the same version of the report that is submitted to Lloyd’s. However, if managing agents are adopting the approach of having separate internal and supervisory reports, Lloyd’s would want to understand the differences between the two reports. Where managing agents plan to take this approach they should engage with their usual contact in the Risk Management and Governance Oversight team to discuss in more detail.