

# **SOLVENCY II**

## **DETAILED GUIDANCE NOTES**

### **MARCH 2010**

## **SECTION 9 - ORSA**





# SECTION 9: ORSA

## Overview

This section outlines the Solvency II requirements for a syndicate's own risk and solvency assessment (ORSA).

The ORSA can be defined as “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”.

There is no requirement for an ORSA or equivalent in the current regulatory environment.

## Guidance

There are no level 2 proposed measures on the ORSA and further guidance from CEIOPS is not expected until later in 2010.

Agents should note that guidance on the ORSA is subject to further discussion with the FSA and is not being issued at this stage but will be made available as soon as possible.

In the meantime, agents should continue to work on their ORSA process.

## Contents

This section includes the following

- Level 1 directive text
- Guidance on ORSA
- Appendix 9a – example template for ORSA report
- Appendix 9b – standing information for ORSA report



# LEVEL 1 AND 2 MEASURES

## Directive Article 45

1. *As part of its risk-management system every insurance undertaking and reinsurance undertaking shall conduct its own risk and solvency assessment. That assessment shall include at least the following:*
  - (a) *the overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the undertaking;*
  - (b) *the compliance, on a continuous basis, with the capital requirements, as laid down in Chapter VI, Sections 4 and 5 and with the requirements regarding technical provisions, as laid down in Chapter VI, Section 2;*
  - (c) *the significance with which the risk profile of the undertaking concerned deviates from the assumptions underlying the Solvency Capital Requirement as laid down in Article 101(3), calculated with the standard formula in accordance with Chapter VI, Section 4, Subsection 2 or with its partial or full internal model in accordance with Chapter VI, Section 4, Subsection 3.*
2. *For the purposes of point (a) of paragraph 1, the undertaking concerned shall have in place processes which are proportionate to the nature, scale and complexity of the risks inherent in its business and which enable it to properly identify and assess the risks it faces in the short and long term and to which it is or could be exposed. The undertaking shall demonstrate the methods used in that assessment.*
3. *In the case referred to in point (c) of paragraph 1, when an internal model is used, the assessment shall be performed together with the recalibration that transforms the internal risk numbers into the Solvency Capital Requirement risk measure and calibration.*
4. *The own-risk and solvency assessment shall be an integral part of the business strategy and shall be taken into account on an ongoing basis in the strategic decisions of the undertaking.*
5. *Insurance and reinsurance undertakings shall perform the assessment referred to in paragraph 1 regularly and without any delay following any significant change in their risk profile.*
6. *The insurance and reinsurance undertakings shall inform the supervisory authorities of the results of each own-risk and solvency assessment as part of the information reported under Article 35.*
7. *The own-risk and solvency assessment shall not serve to calculate a capital requirement. The Solvency Capital Requirement shall be adjusted only in accordance with Articles 37, 231 to 233 and 238.*

**There are currently no proposed level 2 requirements for ORSA. Level 3 guidance on the ORSA is due to be published in early 2011.**



# OWN RISK AND SOLVENCY ASSESSMENT (ORSA)

## Overview

The Framework Directive Proposal, in Article 45, describes the own risk and solvency assessment (ORSA) as a tool of the risk management system that requires (re)insurance undertakings to properly assess their own short and long term risks and the amount of funds necessary to cover them.

The ORSA can be defined as “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”.

The ORSA can be seen as an ongoing process, with periodic formal reporting. The suggested report format set out in Appendix 9a could be used for regular internal reporting, say on a quarterly basis, as well as when there is a material change.

The ORSA must consider all key risks that face the business and will therefore include liquidity, group, reputational and regulatory risks, as well as those included in the SCR. Both internal and external risks should be considered - for example changes in the syndicate business plan and general changes in economic conditions as well as emerging risks. Agents should also ensure that they take account of risks arising from any inadequacies in the system of governance.

One of the key differences between the current ICA and the ORSA is that the ORSA must consider a longer timeframe. Overall the ORSA should pull all the business processes together and give an overview of the business strategy and required capital over a three year period.

It is essential that, above all else, the ORSA process is useful for executives and helps them obtain a real and practical understanding of the risks and capital required to cover those risks. As such the ORSA should include capital, performance and strategic information and should provide management with key information for decision making.

## Outcomes of the ORSA

Whilst no level 2 measures have been published on the ORSA, Lloyd’s has outlined below what it believes an effective ORSA process should result in based on the directive text. Further clarification will be provided once level 3 measures are published in 2011.

Desired outcome	Detail
Economic capital assessment	Agents should note that for syndicates, the basis of setting economic capital will be determined by Lloyd’s
Regulatory capital assessment	SCR as calculated using the internal model
High level strategy	High level strategy in the context of the risk profile, covering, for example, plan to continue at Lloyd’s, growth/diversification plans. This should provide an overview of strategy and capital over the coming three years
Stress and scenario tests	Capital, solvency position and overall business profile under stressed conditions
Capital contingency plans	Including action to be taken if capital is inadequate, or in the event of insolvency
Range of outcomes	A range of outcomes should be assessed (i.e. not just the 1 in 200), to inform/support business decisions

Actions and decisions	Agents should be able to demonstrate that the ORSA process and the process underlying it results in action, including decisions relating to strategy, risk and capital
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## Processes that support the ORSA

For an effective ORSA process a range of supporting processes will need to be in place, which could include the following:

Process	Components
Governance	<ul style="list-style-type: none"> <li>• A clearly defined governance structure around the ORSA process including report production and sign off</li> <li>• Communication/feedback loops throughout the year</li> <li>• Senior management involvement and challenge as part of the ORSA process</li> <li>• Evidence of governance around the ORSA will include committee terms of reference, role of functions, meeting minutes etc</li> </ul>
Internal model	<ul style="list-style-type: none"> <li>• Underpins the ORSA</li> <li>• Provides regulatory capital requirement and basis for longer term capital planning</li> </ul>
Model re-runs	<ul style="list-style-type: none"> <li>• Appropriate risk indicators and stress testing to indicate a required model re-run</li> <li>• Model change policy (see Model Scope and Use section for more detail)</li> </ul>
Assessment of the capital and solvency position	<ul style="list-style-type: none"> <li>• Basis for setting economic capital will be determined by Lloyd's</li> <li>• Business plan, strategy, risk appetite</li> <li>• Diagram of eligible capital vs capital requirements</li> </ul>
Forward looking assessment	<ul style="list-style-type: none"> <li>• Projections of business plans, economic balance sheet and P &amp; L account.</li> <li>• Appropriate capital strategy</li> </ul>
Stress and scenario tests	<ul style="list-style-type: none"> <li>• A robust process for undertaking forward looking &amp; reverse stress tests around the business plan, economic capital requirement and wider business environment</li> <li>• Will assist in understanding sensitivity of results to key assumptions</li> </ul>
Capital and liquidity	<ul style="list-style-type: none"> <li>• Appropriate capital strategy</li> </ul>

planning	<ul style="list-style-type: none"> <li>• Documented Contingency policy and plans</li> </ul>
Independent review	<ul style="list-style-type: none"> <li>• An agreed approach and scope of the independent review of ORSA.</li> <li>• Independent review report</li> <li>• Statement of appropriateness of the internal model.</li> <li>• Limitations of the internal model</li> <li>• Analysis of half year results against expectations.</li> </ul>

## Lloyd's requirements

Lloyd's will expect all agents to have an ORSA process in place and to produce a separate ORSA document for each syndicate. However, where an agent manages more than one syndicate and there is common information, for example the risk strategy, Lloyd's will not expect this to be repeated in each syndicate ORSA.

Whilst both ORSA and reporting requirements will not be finalised until 2011, Appendix 1 provides a template which agents may wish to use to progress their work on the ORSA. Agents should note however that this is based on Lloyd's current view and may change as more detail is published.

It is currently envisaged that the format set out in Appendix 1 would be acceptable for reporting to Lloyd's. Reporting is likely to be on an annual basis and will include other information that Lloyd's specifically requests to meet reporting requirements for the Return to Supervisor and Solvency and Financial Condition Report (see Supervisory reporting and disclosure section for further detail). This may mean that the ORSA submitted to Lloyd's contains more information than agents would include in their internal reporting version, but Lloyd's overall aim will be to ensure that reporting for syndicates is not unduly onerous.

It is not expected that the syndicate ORSAs will directly feed into the Lloyd's ORSA, although Lloyd's will need to ensure that the aggregate of syndicate strategies is consistent with the overall Society level strategy. Syndicate ORSAs will need to be submitted to Lloyd's on an annual basis as a minimum together with the SCR calculation for the following year. Lloyd's will not look to 'approve' the ORSA as such and Lloyd's review will focus on how the ORSA supports and validates capital requirements. More detail of the process for submission and review of syndicate ORSAs will be determined by Lloyd's in due course as more detail is published and requirements are finalised with the FSA.

## ORSA Report

Appendix 9a sets out the **possible** contents of the ORSA "report". Managing agents should be aware that where not described in full in the report or referenced in any appendices, evidence of why management were happy to "approve" the confirmation statement must exist elsewhere. The ORSA itself will need to be a process and the report will need to be submitted to Lloyd's.

The ORSA will contain dynamic information which is updated on a regular basis but it is also expected that it will include "standing" information to support the ORSA, as set out in Appendix 9b. This does not necessarily need to be included as part of the internal ORSA document, but will need to be in place to support the ORSA and agents will need to ensure that they can provide up to date information to Lloyd's as part of their ORSA submission.



# EXAMPLE TEMPLATE FOR ORSA REPORT

## 1. Executive Summary confirmation statement

This should provide an overview of the high level strategy in context of the overall risk profile. Management should be able to confirm that:

- The current risk profile is understood and appropriate for the nature of the business and within the risk appetite of the firm
- Syndicate capital requirements and technical provisions during the reporting period have continuously been met (or if not appropriate action was taken)
- The syndicate's current point in time capital and solvency position is appropriate
- The internal model has been used appropriately for strategic decisions throughout the period
- The dynamics that could likely change the risk profile are understood
- Capital plans to meet the solvency position projected over the required planning period are appropriate including under stressed conditions

## 2. Summary of ORSA Process for the period

- Governance process around the ORSA including challenge and debate
- When has the internal model been re-run and why
- When have the assumptions been reviewed challenged and changed
- Actions management has taken to keep within risk appetite (instances when outside)
- When has the internal model been used strategically and what changes of strategy have there been?
- What have been the material changes to risk profile?
- Any breach of solvency levels?
- Independent validation of the ORSA process

## 3. Capital and Solvency Position and stress testing

- Point in time (reporting date) capital and solvency against SCR
  - summary of capital allocation for each risk category
- Statement of sufficient eligible own funds
- Explanation of the differences between the internal model SCR, and the standard formula
- Results of own, Lloyd's and FSA prescribed stress and scenario tests

## 4. Forecast Capital and Solvency position

- Capital and liquidity plans (including contingency plans) under base case and prescribed stress and scenarios
- Projected capital and solvency position over business planning period (3 years)

## **5. Risk Management information**

- Risk Profiles – material exposure, concentration, mitigation and sensitivity
- Summary of all instances of breaches of risk appetite and how risk strategy changed as a result
- What are the key risks and issues that been identified (internal and external)
- What are the future risks and key dynamic drivers of change (within planning horizon) that have been identified?
- How comfortable is the firm that all risk mitigation works?

## **6. Appendices *(for any other information considered necessary)***

## **7. Standing information**

Appendix 9b sets out examples of 'standing' information which should support the ORSA. This does not necessarily need to be included as part of the internal ORSA document, but agents may need to provide this information to Lloyd's as part of their ORSA submission.

### ORSA – SUGGESTED STANDING INFORMATION

#### **Risk Governance**

- Risk universe
- Risk governance structure e.g. three lines of defence

#### **Risk Management Strategy and Appetite**

- Documented risk management strategy, including how this supports the business
- Risk appetite statements, showing clear top down appetite, with appropriate operational tolerances and limits

#### **Risk Management Process**

- process and procedures for identifying, assessing controlling and prioritising risk, including emerging risk
- Key risks and their assessment

#### **Internal model**

- Scope and definition

#### **‘Use Test’ Explanation**

Description of how risk and capital management activity is integrated into operational activity, including:

- Integration of model into the business
- How strategic decisions have been made using the model
- Drivers for improving the internal model and risk management processes

#### **Business Context**

- Legal and organisational structure, core business activities and market environment.
- Copy of Organisational charts.
- Business Plan