

ORSA

Own Risk & Solvency Assessment

IFE conference
December 7, 2010

Agenda

1 Challenges of Solvency II

2 Governance

3 ORSA

4 Operational Risk

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The challenges of Solvency II for the industry

We can anticipate several impacts of the reform :

- ✓ Need to develop information systems in order to centralize information (especially for large insurers, groups)
- ✓ Need to anticipate the collection of data (especially with regard to the development of an internal model)
- ✓ Improving **governance**, especially **control environment** (formalization, documentation, reporting, ...)

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Overview of the Solvency II Directive

Solvency II Framework Directive – overview

PILLAR I

- Assets and Liabilities - market consistent valuation
- Investments
- Solvency Capital Requirement (SCR):
 - European Standard Formula; or
 - Internal Model
- Minimum Capital Requirement (MCR)
- Own Funds

PILLAR II

- System of governance
- Own risk and solvency assessment (ORSA)
- Supervisory review process
- Supervisory intervention including capital add-on

PILLAR III

- Public Disclosure – annual solvency & financial condition report (SFCR)
- Information to be provided for supervisory purposes (RTS)

General governance requirements

Some risks may only be addressed through governance requirements rather than through quantitative capital requirements.

=> An effective system of governance is essential, and therefore the functions included in the system of governance are key.

The insurer's management body is made ultimately **responsible for compliance** with all laws and regulations in connection with Solvency II.

As part of discharging these responsibilities, they will need to establish effective systems of governance which provide for sound and prudent management.

General governance requirements

The system of governance shall:

- Be proportionate to the nature, scale and complexity of the operations
- Include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities
- Include an effective system for ensuring the transmission of information
- Be subject to regular internal review

General governance requirements

The system of governance will include:

- Risk management
- Internal control
- Internal audit
- Actuarial function
- Outsourcing (if applicable)

=> The insurers must have the administrative capacity to perform governance tasks.

However, unless otherwise specified, insurers can freely decide how to organise those functions (which may be resourced by own staff or outsourced).

General governance requirements

Insurers shall take reasonable steps to ensure **continuity and regularity in the performance** of their activities.

To that end, the insurer should employ appropriate and proportionate systems, resources and procedures.

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Risk Management: ORSA

The **Own Risk and Solvency Assessment (ORSA)** is defined as the entirety of the processes and procedures employed to

- identify, assess, monitor, manage and report the short and long term risks an insurer faces or may face
- determine the own funds necessary to ensure that the insurer's overall solvency needs are met at all times

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.

The management body should regularly understand and assess the risks which the undertaking is exposed to and determine the level of own funds appropriate to its risk and internal control environment.

The ORSA shall be integral to the business strategy and the strategic decisions of the entity.

Risk Management: ORSA

The ORSA should include details of the:

- Overall solvency needs (risk profile, risk tolerance limits, business strategy)
- Assets
- Liabilities
- Technical provisions
- Solvency Capital Ratio / Minimum Capital Requirement
- Internal capital needs

Whilst regulatory capital requirements (MCR and SCR) can only be met by eligible own funds, other elements of capital might be taken into account when assessing an insurer's internal capital needs.

The ORSA should include the extent to which the insurer's risk profile deviates from the assumptions underlying the calculation of its SCR.

Risk Management: ORSA

There may be differences between the capital required for both regulatory capital purposes and the business needs for a number of reasons, including different confidence levels, risk profiles, time horizons and management actions.

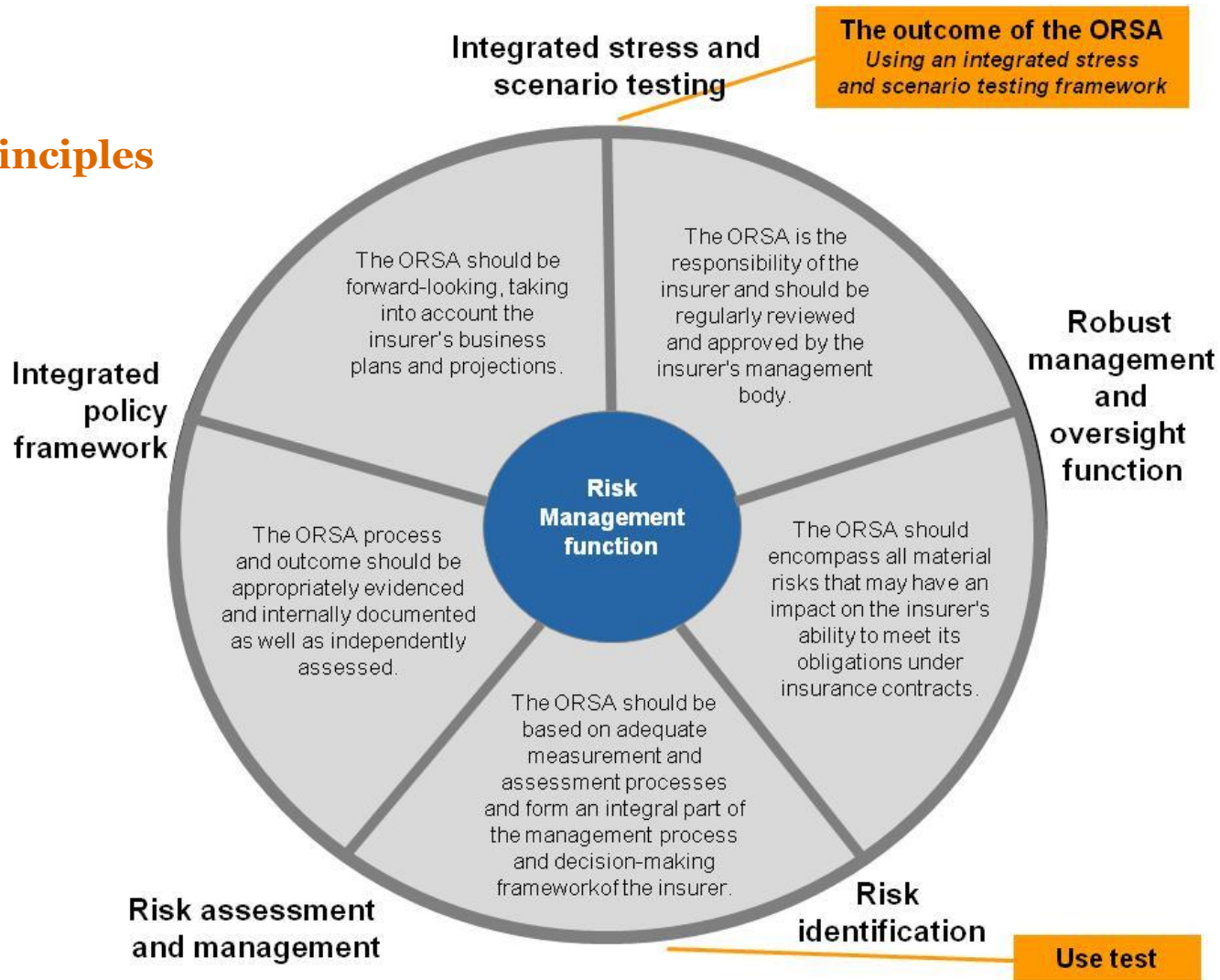
The ORSA should also consider long term projections (incl capital requirements), business plans, economic balance sheet and profit and loss account and take account external factors e.g. changes in economic environment and management actions.

Insurers are required to notify the supervisor of the results of the ORSA which should be performed regularly and if there is a significant change in the risk profile of the entity.

The output of the ORSA, together with other aspects of supervisory reporting, will **allow the regulator to measure the ability of the insurer to assess its solvency needs and to understand the risks to which it is exposed.**

Risk Management: ORSA

The 5 principles



Other significant requirements: the ORSA

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

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

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Operational Risk Management

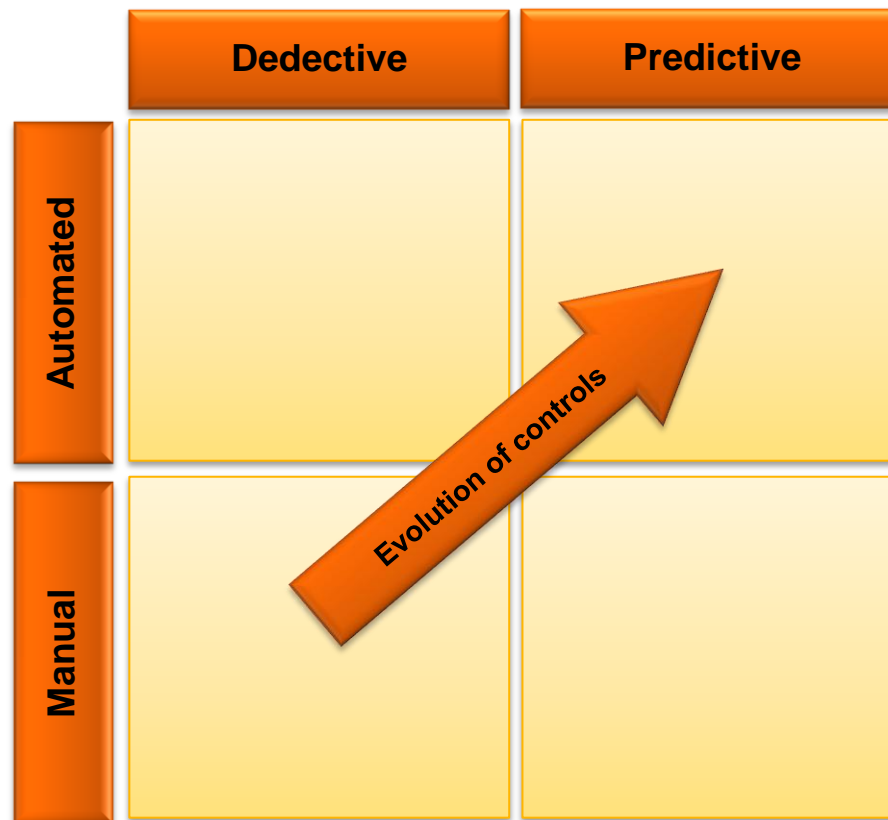
“The risk of loss arising from inadequate or failed internal processes, personnel or systems, or from external events.”

Insurers are required to have in place a well-documented system for operational risk with responsibilities defined.

Management should be familiar with the significant operational risks faced by the insurer and should approve, monitor and review the operational risk management framework.

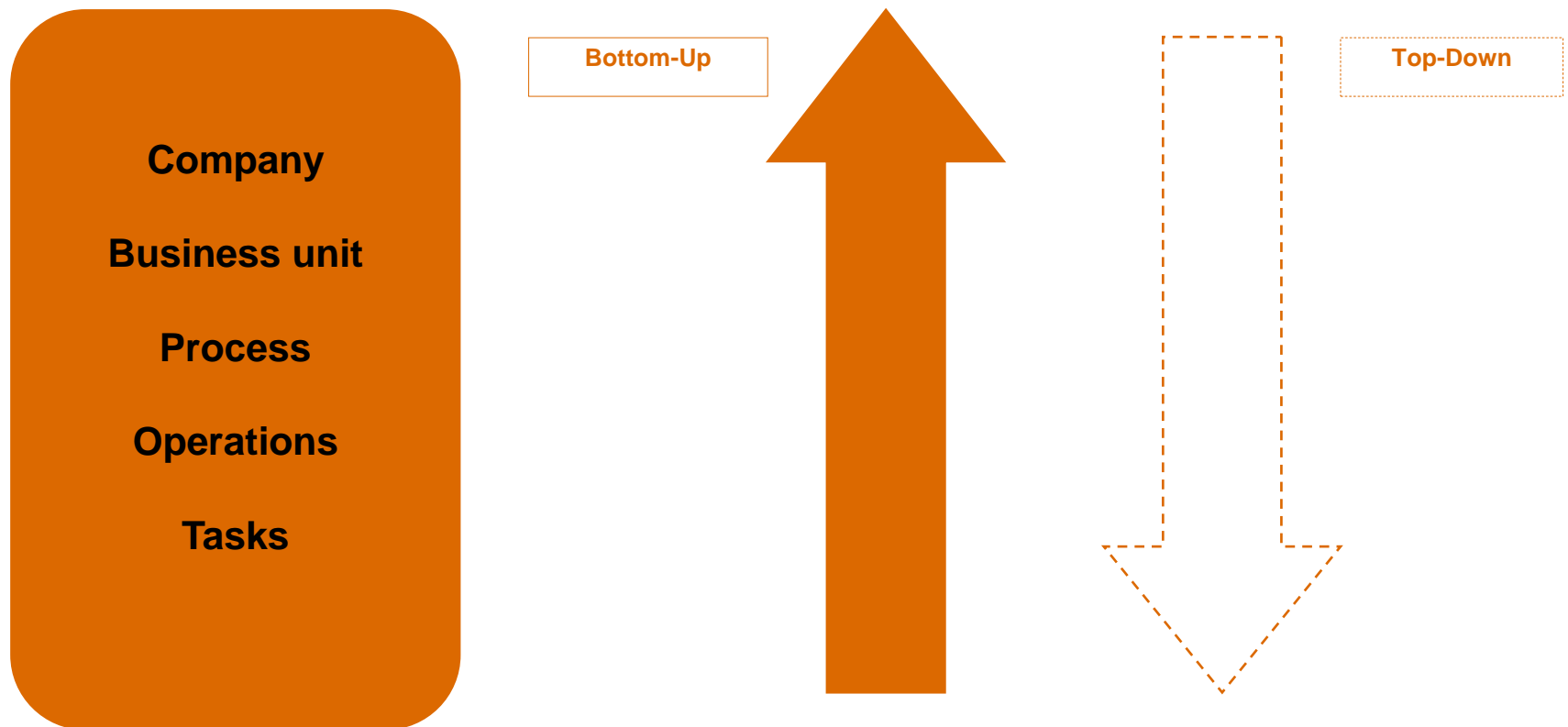
Operational Risk Management

Monitoring operational risks



Operational Risk Management

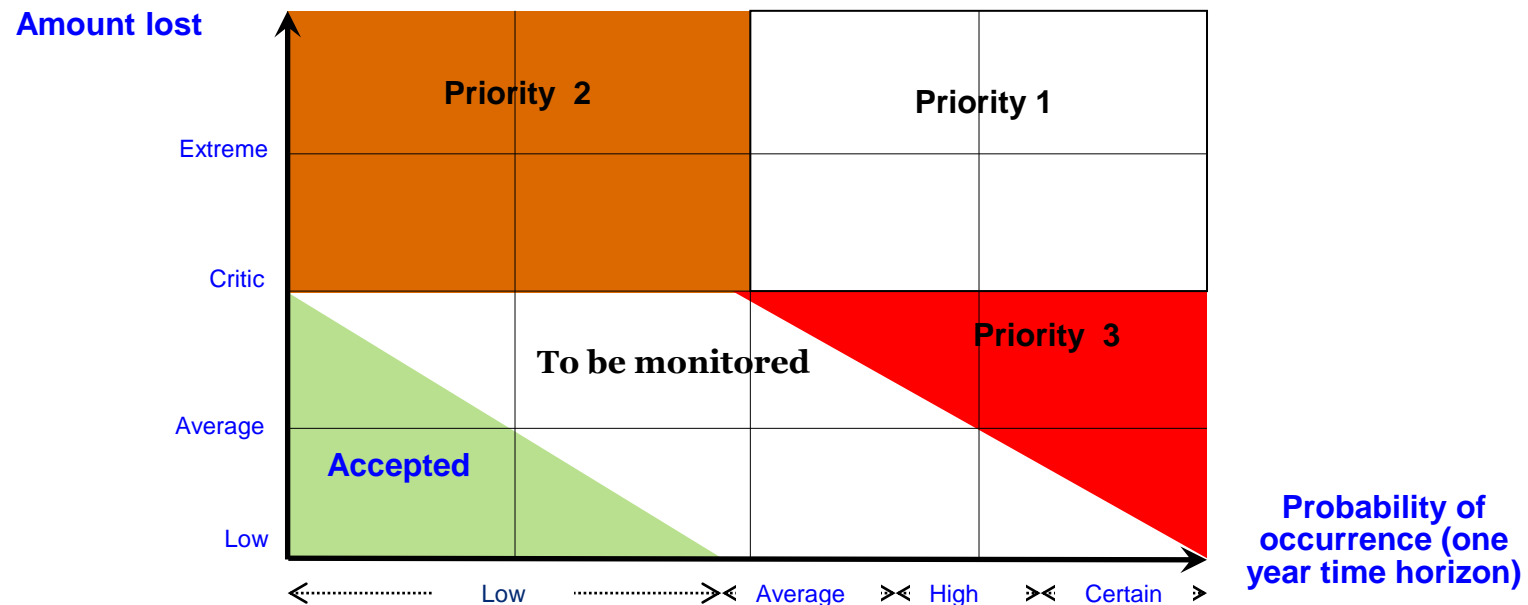
Monitoring operational risks



Operational Risk Management

Creation of the Risk Matrix

- ✓ « **Gross** » **risk**: Level of risk without any controls
- ✓ « **Net** » **risk**: remaining risk after taking into consideration the impact of controls in place
- ✓ **Critical levels**: level of risk that should not be exceeded.



Conclusion

Solvency II represents an exceptional opportunity for insurance- and reinsurance-undertaking to improve their **Risk Management**:

- ✓ Improve the modeling of the risks faced within their activities
- ✓ Improve the modeling of exceptional and unpredictable risks
- ✓ Incentive to develop internal models, more suited to the characteristics of their activity
- ✓ Incentive to take into account **operational risks**
- ✓ The concept of risk should be integrated into the performance measurement
- ✓ Possibility of piloting activity by level of required capital (extreme example: Every time a new insured signed a contract, I know how much capitalized equity it costs)

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