With the introduction of Solvency II, insurance companies must perform their own risk and solvency assessment (ORSA),\(^1\) which will then become a significant component of their risk management system. It will provide a link between risk and capital management and require the active involvement of senior management.

The following aspects have to be assessed:

- The overall capital requirement for the company’s own risk profile; it takes account of the business strategy and internal requirements, for example the risk tolerance defined or a rating target.
- Compliance with capital requirements and rules for technical provisions.
- The use of an appropriate methodology for depicting the risk profile in the calculation of the solvency capital requirement (SCR); this requirement applies equally to users of both the standard formula and (partial) internal models.

The Solvency II Directive sets out the general principles and will be complemented by additional guidelines and recommendations. At the beginning of November 2011, the European insurance supervisor, EIOPA, launched the public consultation on the draft of the Level 3 guideline “Own Risk and Solvency Assessment ORSA”. The document comprised 46 pages with a total of 24 guidelines and recommendations. The main issue was what ORSA was expected to achieve. With a view to the planned introduction of Solvency II on 1 January 2014, EIOPA published the results of the consultation on 9 July 2012.\(^2\) Even though the guidelines and recommendations are not yet final, there are 21 guidelines that companies can use as a basis for their preparations.

The assessment, which can be considered part of the governance system, has a number of objectives, in particular:

- to improve risk management,
- to enhance understanding of the overall capital requirement and the capital allocation,
- to harmonise risk and capital management.

EIOPA received over 700 responses, which were published in its Final Report. Most of the industry commented on EIOPA’s general procedure, considering that the question “What should ORSA’s objectives be?” was more important than “How can the objectives be achieved?” Nevertheless, there were also often differences of opinion on the detail. Views on the level of detail to be included in guidelines varied greatly. For example, the industry would like to see less detail on documentation requirements, but more precise rules on the expectations of the supervisors.

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\(^1\) Cf. Article 45 of the Solvency II Directive of 25.11.2009

regarding the implementation of the ORSA requirements. Companies emphasised that they viewed ORSA as a management tool that, however, should not be used to determine the capital requirement. EIOPA expects the administrative, management and supervisory bodies to possess the qualifications needed to guarantee solid and prudent management of the business.

One thing the industry is requesting is a standard Europe-wide interpretation of the principle of proportionality. Some companies demanded more information on where and how the principle is to be applied in practice, while others expressed their concern that if the SCR calculated did not accurately reflect their risk profile, supervisors might require them to develop their own internal model. According to EIOPA, there will be no hard and fast rules. Nor will the level of detail be increased. Companies will be expected to have the competence and expertise to find the solution that best suits them. In EIOPA’s view, the principle of proportionality can be applied differently from company to company.

There were also many responses on the issue of documentation requirements. The requirement to document ORSA in such a way that the process can be followed and understood by an outsider is an additional hurdle for many insurers. If a separate report is to be produced specifically for ORSA, they see a risk of duplication. EIOPA has made it clear that the documentation requirements in no way mean that all of the documents have to be prepared specially for the purpose of ORSA. The aim is to ensure that the ORSA process can be followed by a knowledgeable outsider, and if existing documentation achieves that, it is acceptable. In addition, it was explicitly stated that companies will not be expected to adapt existing documents to render them 100% user-friendly, but to ensure that the procedure is documented clearly and in full. The industry welcomed the fact that EIOPA did not prescribe a documentation structure for general use in its draft, though it would like EIOPA to provide recommendations for non-mandatory minimum content as a guide.

The ORSA will not confine itself to a one-year period, but also include future periods. EIOPA has moved away from its original requirement for companies to calculate their overall capital requirement for each separate year of the ORSA projection period. Instead, they are to determine the capital requirement over the entire business planning period. EIOPA is aware that it may not be possible to use the same methodology for the multi-year projection as for a single year. The projection should include possible changes in the risk profile and the business strategy over the entire projection period.

EIOPA has refrained from introducing exceptions for certain types of insurer such as captives, mutual insurance societies or monoliners, or for specific insurance groups. EIOPA does not see the need to publish further guidelines for groups headquartered in third countries.

The Solvency II Directive limits the ORSA requirements to insurance groups within the EU, so that EIOPA does not see the need to publish the revised guidelines and recommendations.

If the ORSA produces a deviation between the overall capital requirement and the SCR, the company must give the reasons for this and highlight the effects on the calculation of the SCR. According to the guidelines, the company must be able to demonstrate to the supervisor whether the deviation is significant or not.

Companies can determine the date of the risk and solvency assessment themselves. The date on which the ORSA report is to be submitted to the supervisory authority is defined in the Level 2 implementing measures. Since companies are obliged to determine the deviation between the risk profile and the SCR, EIOPA will expect the ORSA date to be close to the SCR date.

The Solvency II Directive limits the ORSA requirements to insurance groups within the EU, so that EIOPA does not see the need to publish further guidelines for groups headquartered in third countries.

The consultation paper contains no information on what the supervisory authorities will do with the information in the ORSA report. Reference is merely made to the language in which the report is to be prepared. The expectation is that the Group ORSA report will have to be in the same language as the Regular Supervisory Reporting at group level.

The table below summarises the revised guidelines and recommendations.
Conclusion

ORSA will be an important component of the risk management system and corporate management at insurance companies. It will encourage the establishment and maintenance of an appropriate risk culture. In their risk strategy, insurers will define the extent to which they can and wish to incur risks. Management must decide whether risk mitigation techniques such as risk transfer through reinsurance are appropriate, or whether it is possible to diversify the risks. ORSA can thus also be seen as providing a link between risk and capital management.

Munich Re supports its clients and enhances the efficiency and effectiveness of their risk management with broad portfolio diversification and attractive reinsurance solutions. Solvency Consulting has amassed a wealth of experience in dealing with the standard formula, the development and use of (partial) internal risk models and their linkage to value-based portfolio management. Munich Re also plays an active role in industry committees looking at regulation and specialist issues and ensures that knowledge and expertise are transferred and translated into practical recommendations for action on the ground. We are thus able to offer our clients real and ongoing help in preparing for Solvency II.

Guideline 1 Principle of proportionality
Every insurer should develop its own processes for the ORSA, tailored to fit into its risk management system, taking into consideration the nature, scale and complexity of the risks inherent to the business.

Guideline 2 Role of administrative, management or supervisory body
The administrative, management or supervisory body should take an active part in the ORSA process.

Guideline 3 Documentation
A company should have in place at least the following documentation on the ORSA:
- ORSA policy
- Record of each ORSA
- Internal report on ORSA
- ORSA supervisory report

Guideline 4 ORSA policy
The ORSA policy should include at least:
- a description of the processes and procedures in place to conduct the ORSA including how the forward-looking perspective is addressed;
- the link between the risk profile, the approved risk tolerance limits and the overall solvency needs;
- information on stress tests, sensitivity analyses, data quality requirements, the frequency and timing of the performance of the ORSA, and the circumstances which would trigger the need for an ORSA outside the regular timescales.

Guideline 5 General rule
The ORSA and its results should be appropriately evidenced and internally documented.

Guideline 6 Internal report on ORSA
Once the process and the result of the ORSA have been approved by the administrative, management or supervisory body, information on the results and conclusions should be communicated to all staff for whom the information is relevant.

Guideline 7 Valuation and recognition
A company must be able to justify its decisions and explain their impact.

Guideline 8 Assessment of the overall solvency needs
A company should express its overall solvency needs in quantitative and qualitative terms. To this end, it should subject the risks to stress tests/scenario analyses.

Guideline 9 Forward-looking perspective
A company's assessment of the overall solvency needs should be forward-looking and cover the planning period.
| Guideline 10 | Regulatory capital requirements | Companies should ensure that they comply with the regulatory capital requirements. This should include, as a minimum, an assessment of: - potential future changes in the risk profile and the economic situation; - the quantity and quality of its own funds over the whole of its business planning period; - the composition and quality of own funds (tiering) and potential changes. |
| Guideline 11 | Technical provisions | The actuarial function should provide input for the assessment of the calculation of technical provisions and the risks arising from this calculation. |
| Guideline 12 | Deviations from assumptions underlying the SCR calculation | Insurers must assess deviations between their risk profile and the assumptions underlying the SCR calculation on a qualitative basis. |
| Guideline 13 | Link to the strategic management process and decision-making framework | Insurers must take the results of the ORSA and the insights gained in the process into account in defining their medium-term business strategy. |
| Guideline 14 | Frequency of the ORSA | The ORSA should be performed at least annually and take into account the company’s risk profile and the volatility of its solvency requirements. The timing of the ORSA should be such that the SCR calculation and the ORSA can be based on the same risk profile. |
| Guideline 15 | Scope of the group ORSA | A group should design the group ORSA to reflect the nature of the group structure and its risk profile. |
| Guideline 16 | Reporting to the supervisory authorities | The ORSA report sent to the group supervisor should be in the same language as the group Regular Supervisory Reporting. |
| Guideline 17 | Assessment of overall solvency needs | The group ORSA should adequately identify, measure, monitor, manage and report all risks and interdependencies to which the group is exposed. |
| Guideline 18 | General rule for group ORSA | The documentation process for insurance groups should include: - identification of the sources of own funds within the group if additional own funds are necessary; - an assessment of availability, transferability and fungibility of own funds; - references to any planned transfer of own funds within the group and its consequences; - a comparison of individual strategies with those established at group level; - specific risks the group could be exposed to. |
| Guideline 19 | Specific requirements for a single ORSA document covering the participating insurer or reinsurer or the insurance holding company and any subsidiary in the group | Explanation of how the subsidiaries are to be covered and how the subsidiaries’ administrative, management or supervisory body is to be involved in the assessment process and approval of the outcome. |
| Guideline 20 | Internal model users | The group should name subsidiaries that do not use an internal model to calculate their SCR and give the underlying reasons for that in the group ORSA report. |
| Guideline 21 | Integration of subsidiaries in third-countries | In the group ORSA, the group should assess the risks of the business in third countries in the same manner as for EEA business. |