IMPLEMENTATION OF ORSA REPORT IN SOLVENCY II PREPARATION PHASE

The European Union has been facing outdated and fragmented insurance regulatory and supervisory framework for decades. The Solvency I Directive is not risk-sensitive, it contains a few quality requirements related to risk management and business operation of insurance companies and therefore does not provide the supervisors adequate information about underwriting process. The new European legislative framework is based on risk and strengthens protection of the insurance beneficiary, by using the latest development trends in risk-based supervision, actuarial science and risk management. Solvency II encourages insurance companies to explicitly define their own risk tolerance and risk profile and requires the board members to make their business decisions bearing in mind their consequences to the economic capital.

Solvency II is the new regulatory framework for overall business operations of insurance and reinsurance companies in the European Union, revising the current capital requirements, and introducing new, more strict rules of solvency, risk management and supervision process based on risks and the new method of reporting and disclosing, all for the purpose of protecting policy holders and insurance beneficiaries and preventing disruption of the insurance market. Financial stability and fair and stable markets are the goal of the insurance and reinsurance regulations that also need to be considered.

Under Solvency II capital requirements are set based on insurance or reinsurance companies risk profiles, taking into account the governance method, i.e. the efficiency of insurance and reinsurance companies in managing the risks they are exposed to.

By Serbian Insurance Law from 2014, Solvency II regime will be implemented in the moment Serbia joins European Union. Until Solvency II full implementation, Serbian insurance companies should prepare themselves step by step for transition from Solvency I to Solvency II regime. One of important step is ORSA report. This paper will have in focus an ORSA report, will give explanation for Forward Looking Assessment of Own Risks based on the ORSA principles and will show practical aspects of writing ORSA report in Solvency II preparation phase.

1. ORSA

The major principles the Solvency II is based on are:

- a requirement of the overall balance sheet and a consistent evaluation of assets and liabilities in order to have realistic basis for risk assessment
- two capital requirements (Minimum Capital Requirement – MCR and Solvency Capital Requirement – SCR) which ensure the risk-based calculation, but also a stronger and simpler foundation for the final action of the supervisory agencies, an updated access to group supervision with specified group solvency requirements and clear responsibilities of the supervisor
- robust business operation system, including the definition of the number of key functions
- Own Risk and Solvency Assessment (ORSA) which is now considered as international best practice for supervisory agencies reporting templates which are in line with the laws of the European Union and enhanced public disclosure.

In contemporary macroeconomic reality the use of risk-based approach and basic principles of Solvency II are necessary drivers of change. European Insurance and Occupational Pensions Authority (EIOPA) shall observe closely any unwanted material consequence of implementing Solvency II, especially a negative impact on insurance beneficiaries.

Solvency II has a three pillar approach. Pillar 1 refers to the insurance of adequate financial resources of insurance and reinsurance companies and includes quantitative requirements which include determining own funds, technical reserves calculation, evaluation of assets and liabilities, and calculation of Solvency Capital Requirement and Minimum Capital Requirement. Pillar 2 refers to the implementation of adequate governance of insurance and reinsurance companies, so that it includes qualitative requirements for establishing efficient governance system, governance system key functions, Own Risk and Solvency Assessment implementation and process of supervision over insurance and reinsurance companies based on forward-looking and risk-based approach. Pillar 3 of Solvency II includes new rules of reporting to the supervisory authority, public disclosure and market discipline.

Own Risk and Solvency Assessment consists of insurers' procedures and processes for identification, assessment, management and reporting about the risk the company may face, in order to set the required funds for providing complete solvency of the company. ORSA must take into account business strategies[1], i.e. how the strategies are set in terms of risk appetite and current risk profile (all the key risks the insurer faces) and to assess the amount of capital required to run business operations during a scheduled timeframe of several years, as well as SCR and the adequacy of own funds. Each insurer is required to implement ORSA on a regular basis. ORSA is not the same as internal model – its scope is wider than that of the internal model. In the process of implementing ORSA each company must set up the ORSA policy, internal documents, and documentation for the supervisor and for the public.

The area that requires special implementation efforts are the qualitative requirements of Solvency II, such as Own Risk and Solvency Assessment. The assumption[2] is that the insurance companies will be focused on capital requirements, whereas ORSA will come second on their list of priorities. That is a big mistake, because when reducing risk it is wrong to consider only required capital. The capital cannot cover deficiency of good management! One of the crucial principles of Solvency II is an integrated consideration of risk and capital. In new legislation Own Risk and Solvency Assessment is important management tool which connects risk management and capital management.

When considering "overall solvency needs" as a part of ORSA, the companies should consider their risk profile, the established risk tolerance limit and business strategy. In addition, ORSA must present the risk mitigation techniques which the companies intend to use in order to manage the risks they are exposed to.

Therefore, the basis of ORSA is not regulatory requirements. On the contrary, Own Risk and Solvency Assessment is based on each company's DNA, i.e. its business strategy. ORSA enables insurers to determine the adequacy of their regulatory capital position, and therefore can help the management to control its liability so they do not accept too much risk, more than their capitals allow. Also, it is expected that determining "overall solvency needs" within ORSA will facilitate a number of important strategic decisions, such as defining risk retention level, capital management optimization methods and setting adequate levels of premium. Effective ORSA can also provide useful insight into the efficiency of capital in management's future business activities and the enable companies to estimate the efficiency of long-term capital of certain products and help creation of new insurance policies.

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[1] Ilić M. (2014). *Uticaj primene direktive Evropske unije „Solventnost II" na sektor osiguranja u Srbiji*

[2] Bernardino G. (2015). Solventnost II nije savršen regulatorni okvir, ali... *Svijet osiguranja* br. 9. god. 2015.

ORSA is a shift in management culture which must start from the top. It requires a lot of time, dedication and especially, clear instructions from the top. That is why top management has the crucial role in ORSA implementation. It is their job to establish, communicate and implement a strong risk culture which consistently affects, dictates and adjusts to the business strategy and goals, and thus supports the setup of the framework and process of own risk management. The implementation of ORSA is an excellent opportunity to additionally establish a strong risk culture into insurers' daily business operations, simultaneously allowing time for adequate balance with sales culture. Actually, when establishing a risk culture, an important element is to make sure the analysis of risk and its effects on the capital are explicitly taken into account when strategic decisions of the company are being made. If done properly it brings investment, otherwise it produces costs.

The EU Directive, adopted by the European Parliament in December 2013, set the deadlines for application of Solvency II. The deadline for transposition of provisions of Solvency II Directive into national legislations of the European Union member states was March 31, 2015, and the deadline for implementation of Solvency II to the insurance and reinsurance companies' business operations was January 1, 2016. The Directive 2014/51/EU Omnibus II complements the Solvency II Directive regarding the powers of a new supervisory authority EIOPA.

2. GUIDELINES ON FORWARD LOOKING ASSESSMENT OF OWN RISKS BASED ON THE ORSA PRINCIPLES

EIOPA issues Guidelines (document code EIOPA-CP-13/09) addressed to national insurance regulators on how to proceed in the preparatory phase leading up to the application of Solvency II Directive. During interim phase insurance companies will need to meet the interim Solvency II requirements in addition continuing to comply with existing Solvency I requirements.

In EU this phase is finished and Solvency II full implementation already started, but in Serbia, these interim requirements will be the first next step in implementation of Solvency II regime.

These Guidelines should be seen as preparatory work for Solvency II by fostering preparation with respect to key areas of Solvency II in order to ensure proper management of insurance and reinsurance companies and that supervisors have sufficient information at hand. These areas are the system of governance, including risk management system and a Forward Looking

Assessment of Own Risks based on ORSA principles, pre-application for internal models, and submission of information to insurance supervisor.

Table 1. List of Guidelines on Forward Looking Assessment of Own Risks Based on the ORSA Principles

1.	General provisions for Guidelines
2.	Progress report to EIOPA
3.	Applicability of the threshold for the Forward Looking Assessment of Own Risks
4.	Proportionality
5.	Role of the administrative, management or supervisory body: top-down approach
6.	Documentation
7.	Policy for the Forward Looking Assessment of Own Risks
8.	Record of each Forward Looking Assessment of Own Risks
9.	Internal report on the Forward Looking Assessment of Own Risks
10.	Supervisory Report of the Forward Looking Assessment of Own Risks
11.	Valuation and recognition of the overall solvency needs
12.	Assessment of the overall solvency needs
13.	Forward-looking perspective of the overall solvency needs
14.	Regulatory capital requirements
15.	Technical provisions
16.	Deviations from assumptions underlying the SCR calculation
17.	Link to the strategic management process and decision making framework
18.	Frequency
19.	Scope of group Forward Looking Assessment of Own Risks
20.	Reporting to the supervisory authorities
21.	Assessment of the impact of group specific risks on overall solvency needs
22.	General rule for group Forward Looking Assessment of Own Risks
23.	Specific requirements for a single Forward Looking Assessment of Own Risks' document
24.	Internal model users
25.	Integration of related third-country insurance and reinsurance undertakings

Source: EIOPA (2013). Guidelines on Forward Looking Assessment of Own Risks (based on the ORSA principles)

There are 4 chapters in Guidelines:

I: General provisions for preparatory guidelines

II: Forward Looking Assessment of Own Risks

III: Specific features regarding the performance of the Forward Looking Assessment of Own Risks (based on the ORSA principles)

IV: Specificities of the group in the Forward Looking Assessment of Own Risks (based on the ORSA principles)

As part of the preparation for the implementation of Solvency II, national insurance supervisor should put in place from some date, a few years before full Solvency II implementation deadline, the Guidelines as set out in this document so that insurance and reinsurance companies take appropriate steps to full implementation of Solvency II.

In the preparatory phase national insurance regulators are expected to ensure that insurance and reinsurance companies take a forward looking view on the risks to which they are exposed similar to what they will have to do once Solvency II will apply. For this, it is expected that insurance and reinsurance companies actively prepare and begin the implementation of the Forward Looking Assessment of Own Risks (based on the ORSA principles) according to Article 45 of Solvency II Directive.

Since the assessment of the overall solvency needs can be undertaken irrespective of what regulatory quantitative requirements are applicable (Solvency I or II), national insurance regulator are expected to ensure that insurance and reinsurance companies perform such an assessment immediately.

The assessment of the continuous compliance with regulatory capital requirements and the requirements on technical provisions according to Solvency II Directive and the assessment of the significance of the deviation of the risk profile of an undertaking from the assumptions underlying the calculation of the SCR have a strong connection to Solvency II quantitative requirements which are not yet applicable during the preparatory period.

The Guidelines focus on what is to be achieved by this assessment rather than on how it is to be performed. For example, since the assessment of overall solvency needs represents the company's own view of its risk profile, and the capital and other means needed to address these risks, the company should decide for itself how to perform this assessment given the nature, scale and complexity of the risks inherent in its business.

It is crucial that the administrative, management or supervisory body (AMSB) of the company is aware of all material risks the undertaking faces, regardless of whether the risks are captured by the SCR calculation and whether they are quantifiable or not. It is also vital that the AMSB takes an active role in the Forward Looking Assessment of Own Risks by directing the process and challenging the outcome.

The Guidelines apply to both individual company and at the level of the group. Additionally, the Guidelines address issues relevant to the group specificities of the Forward Looking Assessment of Own Risks.

Duties[3] in Forward Looking Assessment of Own Risks Based on the ORSA Principles:

1. Insurance supervisor should:
   - Require insurance companies representing at least 80% of the market share to perform an assessment of whether companies would comply on a continuous basis with the Solvency II regulatory capital requirements and the requirements on the technical provisions;
   - Send to EIOPA, a progress report on the application of these Guidelines.

2. Insurance companies should take the appropriate steps to:
   - Establish a process to develop a Forward Looking Assessment of Own Risks and compile qualitative information supporting the Forward Looking Assessment of Own Risks that will allow insurance supervisor to review and evaluate the quality of the process;
   - Develops own processes with appropriate and adequate techniques, tailored to fit into its organizational structure and risk-management system;
   - Have at least the following documentation:
     - The policy for the Forward Looking Assessment of Own Risks should include at least:
       - A description of the processes and procedures in place to conduct the Forward Looking Assessment of Own Risks;
       - A consideration of the link between the risk profile, the approved risk tolerance limits and the overall solvency needs;
       - Information on how and how often stress tests, sensitivity analyses, reverse stress tests or other relevant analyses are to be performed, data quality standards, the frequency of the assessment itself and the justification of its adequacy particularly taking into account the risk profile and the

[3] *http://www.hanfa.hr*

volatility of its overall solvency needs relative to its capital position and the timing for the performance of the forward looking assessment;

  - Record of each Forward Looking Assessment of Own Risks
  - An internal report on each Forward Looking Assessment of Own Risks
  - A supervisory report of the Forward Looking Assessment of Own Risks should present at least the following:
    - The qualitative and quantitative results of the forward looking assessment and the conclusions drawn;
    - The methods and main assumptions used;
    - A comparison between the overall solvency need, the regulatory capital requirements and the company's own funds;
- Explains how the use of different recognition and valuation bases ensures better consideration of the specific risk profile if it uses recognition and valuation bases that are different from the Solvency II bases;
- Assesses its overall solvency needs and then expresses it in quantitative terms and identify material risks to a sufficiently wide range of stress test or scenario analyses;
- Assessment of the overall solvency needs is forward-looking, including a medium term or long term perspective;
- Analyses whether would comply on a continuous basis with the Solvency II regulatory capital requirements;
- Ensures the actuarial function of the undertaking to provide input as to whether the company would comply continuously with the requirements regarding the calculation of technical provisions and identify potential risks;
- Assesses whether its risk profile deviates from the assumptions underlying the Solvency II Solvency Capital Requirement calculation;
- Takes into account the results of the Forward Looking Assessment of Own Risks and the insights gained during the process of this assessment in at its capital management, business planning product development and design;
- Performs the Forward Looking Assessment of Own Risks at least annually.

3. Group of insurance companies should take the appropriate steps to:

- Designs the group Forward Looking Assessment of Own Risks to reflect the nature of the group structure and its risk profile;
- Assesses in the assessment of the group overall solvency needs the risks of the business in third countries in a consistent manner;
- Adequately assesses the impact of all group specific risks and interdependencies within the group;
- Includes in the record of the group Forward Looking Assessment of Own Risks at least a description on how the following factors were taken into consideration:
    - The identification of the sources of own funds within the group;
    - The assessment of availability, transferability or fungibility of own funds;
    - References to any planned transfer of own funds within the group;
    - Alignment of individual strategies with the ones established at the level of the group;
    - Specific risks the group could be exposed to;
- Provides an explanation of how the subsidiaries are covered;
- Describes which entities within the group do not use the internal model to calculate their SCR and explain why in the case of an internal model pre-application.

4. Insurance group supervisor should form a view whether to allow the group to perform a single Forward Looking Assessment of Own Risks document and decide about language which will be used in ORSA.

As preparation for Solvency II ORSA report, this forward looking process report should contain[4]:

- a description of processes and procedures in place,
- consideration of the link between the risk profile, the approved risk tolerance limits and the overall solvency needs,
- information on frequency of analyses and tests,
- data quality standards,
- justification of its adequacy,
- the frequency of the assessment,
- the timing of the assessment, including the circumstances in which an ad-hoc assessment is required.

[4] Munich Re (2013). *EIOPA's view on Forward-Looking Assessment of Own Risks (FLAOR)*

All companies are faced with a number of key challenges to prepare that report. Some of the most difficult[5] are: projection of balance sheet and capital requirements, demonstration of continuous compliance and process documentation.

3. ORSA REPORT

Solvency II regulation don't provide structure of ORSA report. Also, there are no rules about obligatory and optional content of report. Idea of EIOPA is to allow every company to make report tailored by own needs. This paper will show one of possible implementation of an ORSA report, which is not fit for any specific company, but should help for better understanding of ORSA requirements. ORSA report should include following: governance statement of risk management system, risk governance and management, including related assessment and improvement areas, business strategy update, risk strategy and verification of its adequacy, risk measurement and models results, including the main risk identification and assessment.

An ORSA report could have following chapters:

1. Prolegomenon
2. Risk management
3. Business strategy
4. Risk strategy
5. Risk measurement
6. Forecast solvency position

3.1. Prolegomenon

Possible content of the first chapters could be confirmation statement, ORSA objectives and scope. Compliance with local solvency regulation and company's risk legislation should be mention here. Here is good place to be quoted appropriate parts of company's risk policy and risk management strategy.

[5] Milliman (2013). *Key challenges of producing a Forward Looking Assessment of Own Risk*

Executive Summary Confirmation Statement[6]

This part 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 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

ORSA Objectives

The most important objective of this ORSA Report is to provide company's management with the overall Risk Profile, the Solvency Ratio, results of the main risk assessments, etc.

Company's risk profile and risk assessment methodology is always in scope of this report. Since in Solvency II preparation period there is no standard formula calculation, company's current capital position determined through existing Solvency I model is very important part of ORSA report.

3.2. Risk Management

Company Structure and Corporate Governance

Organizational chart of the company should be disclosed and especially emphasized 4 risk control functions, introduced by Solvency II: Internal audit, Compliance, Actuarial Function and Risk Management. It is good to list risk owners within company and describe of main governance bodies: Management Board, Risk Committee, etc. key activities.

An example of Actuarial Function key activities[7]: "Actuarial function is responsible for the calculation and validation of the technical provisions, for the

[6] Lloyd's (2010) *Solvency II detailed guidance notes, Section 9 – ORSA*, http://www.lloyds.com

adequacy of the mathematical provision and other reserves, as well as the adequacy of the tariffs."

Risk Governance and Management

Risk management function is responsible for:

- Managing risk policies and guidelines,
- Defining and coordinating Risk Management activities,
- Implementation of the risk assessment methodologies,
- Measuring, monitoring and reporting the Risk Profile,
- Defining, modifying and managing key decisions within the Risk Management function,
- Supporting the risk owners in measuring and mitigating their risks,
- Reporting, etc.

Company should disclose the last material change of the risk profile and actions management has taken to keep within risk appetite.

Management is entitled to provide independent validation of ORSA process.

Risk Profile

Material exposure, concentration, mitigation and sensitivity of risk are parts of the risk profile. Key internal and external risks should be identified and future risks forecasted within planning horizon of a few years. Also summary of all instances of breaches of risk appetite should be disclosed and how the risk strategy changed as a result of it.

Data Quality

Fulfillment of some of following data quality requirements[8] is important to be assessed:

- Embed a system of data quality management across the entity,
- Define and monitor processes for identification, collection, transmission, processing and retention of data,
- Ensure data processing from source to model is transparent and demonstrable,

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[7] Generali osiguranje d.d. Zagreb (2015). *Own risk and Solvency assessment (ORSA) report*

[8] EY, Solvency II and EIOPA requirements in relation to data, *http//:www.ey.com*

- Establish a data policy which sets out the entity's approach to managing data quality,
- Perform periodic data quality assessments, and implement a process for identifying and resolving data deficiencies,
- Document instances where data quality may be compromised, including implications and mitigating actions,
- Establish a process to manage changes or data updates which materially impact model outputs, etc.

3.3. Business Strategy

Business Plans

Macroeconomic parameters of the country and development trend of insurance market are basis for a realistic business strategy. Mentioned details together with company’s business plans by line of business should be described in this chapter.

The company’s long term strategy especially about reinsurance is very important for risk mitigation. Investment strategy also should be disclosed to be able to understand future assets portfolio changes and related risks.

Company Planning Process

Description of planning process from target setting phase to monitoring process with defined responsible company’s functions and deadlines should be in this section of ORSA report.

3.4. Risk Strategy

Risk Appetite

Risk appetite represents selection of risks which company prefers to take or to avoid. This section mandatory contain risk appetite statement. Company’s risk preferences should be listed and shortly described to support understanding of risk appetite. Risk metrics and targets are also part of this part of ORSA report, e.g. Solvency Ratio target lower than some level.

Risk governance documents

Full internal and external regulation of risk governance should be listed here. List of documents contains international standards, local law and sub-law acts, company's guidelines and procedures, etc.

Link between Risk Profile, Risk Appetite and solvency

Considerations of the link between the Risk Profile, the approved risk tolerance limits and the overall solvency needs should be written in this section.

3.5. Risk Measurement

This section is the most important and has the greatest volume of ORSA report in Solvency II regime. It should contain Solvency II Ratio, Eligible Own Fund, output from Standard Formula calculation, impact of different risks on Standard Formula results, different type of risk analysis, Liability Adequacy Test for life insurance and Best Estimate Liability calculation of technical reserve in non-life insurance, etc. Also result of stress tests and all details about scenarios and their impact of company's results should be here.

Since Serbia is still in Solvency I regime, Standard Formula calculation could not be implemented. This part of report should disclose Solvency I Ratio and other similar calculations, as insurance provision adequacy, checking impact on company's result of some scenarios, etc.

3.6. Forecast Solvency Position

Last chapter is devoted to capital and liquidity plans, including contingency plans under base case and prescribed stress and scenarios. Projected capital and solvency position should be estimated over planning period, e.g. 3 years.

3.7. Future development of ORSA Report in Serbia

After EU joining, Serbia will implement full Solvency II regime and ORSA Report requirements will move to EIOPA Guidelines on Own Risk and Solvency Assessment (document code EIOPA-BoS-14/259). Under new regime, ORSA Report will be more complicated, but much more useful for all stakeholders.

The supervisory authorities' main goal is protecting the users of insurance services. The national legislators are encouraged to strengthen the framework of independence and responsibility. It is crucial in order to ensure the supervisory decisions are made independently from other industries or political influences. If implemented properly, the Solvency II Directive is a solid step towards financial stability, better business transparency and increased user protection.

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