

Solvency II

Own Risk and Solvency Assessment (ORSA)

July 2010



Background



What is ORSA?

- ORSA is a collection of processes' and activities that continuously shall ensure the company's Solvency situation through risk identification, assessment, measurement, management and reporting (both short and long term).
- ORSA aims to help companies obtain a holistic view of their risk profile and understand how risks affect the future solvency situation.
- ORSA belongs to Pillar II and is an important part of the Supervisory Review Process.

What is required by the ORSA?

- An ORSA will be required, irrespective of whether companies are using the standard formula or an internal model
- ORSA must be integrated in the business process
- ORSA must be forward-looking and take account of business plans and projections
- All material risks must be assessed. This includes,
 - Risks covered by the SCR calculation
 - Risks not covered or partly covered by the SCR calculation
 - Risk mitigating measures
 - Governance
 - All assumptions used in the risk assessment
- ORSA must be developed by the company and be part of the day to day processes'
- ORSA must be conducted at least on a yearly basis

What is required by the ORSA? (cont'd)

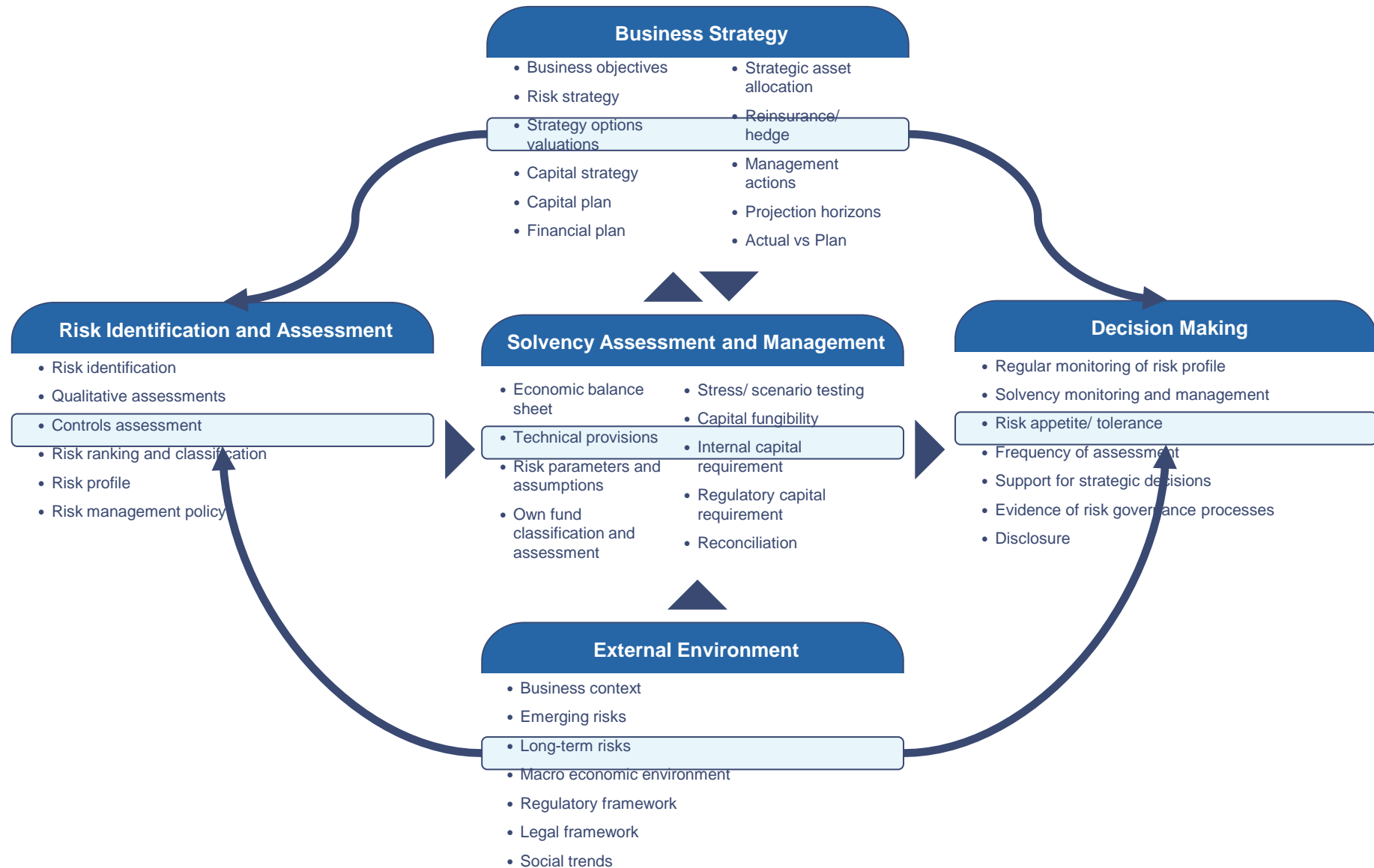
- Companies must explain and justify
 - Methods and assumptions In the risk assessments
 - Results, including sensitivities in the results
 - Appropriateness of the assessments and the model
 - Data sources, systems and controls that affect the ORSA
 - Method for parameter uncertainties
- The ORSA process and the results must be reviewed by an independent part
 - Internal audit, external auditors or other independent reviewer
 - Reviewed at least on an annual basis

Some clarifications

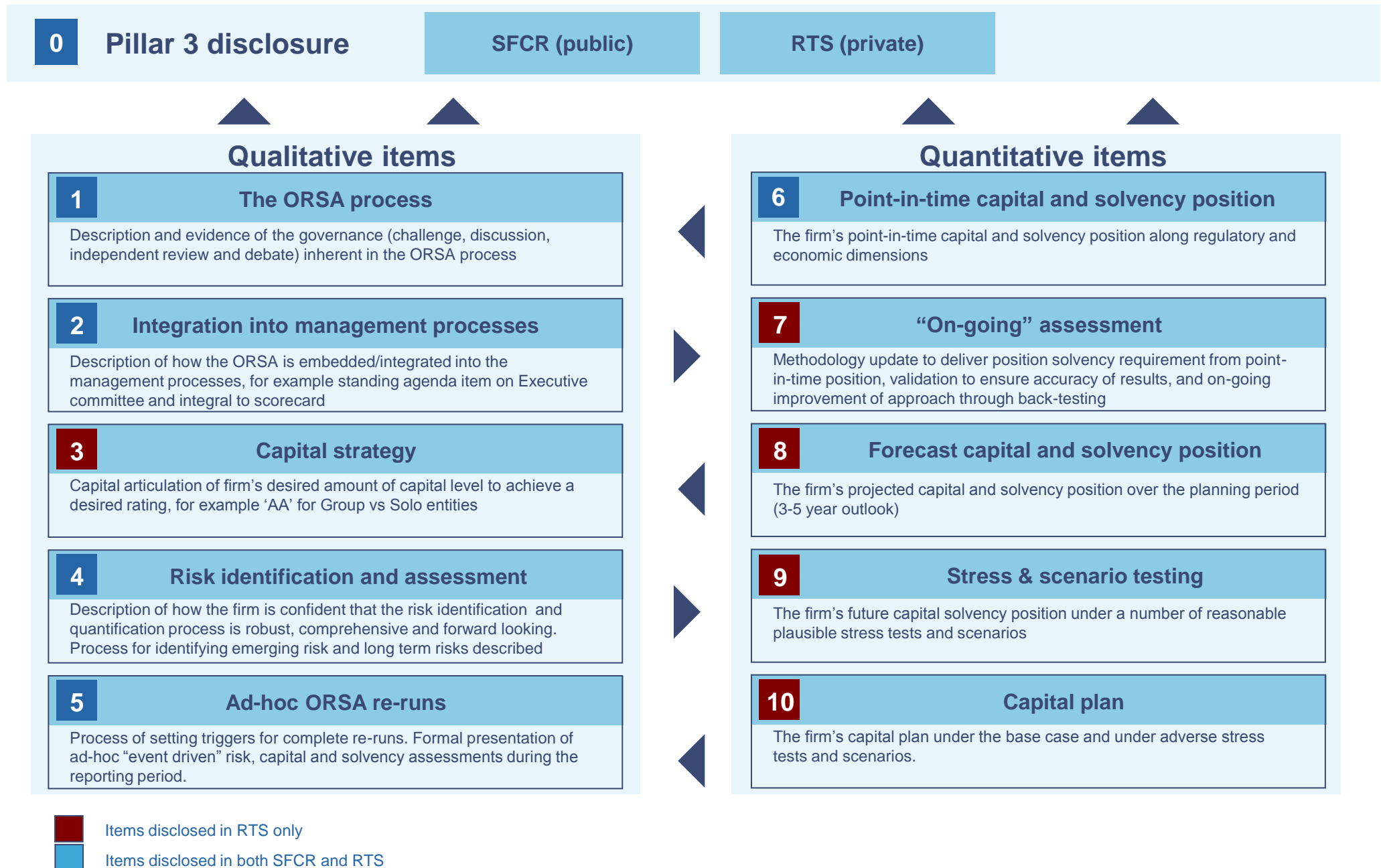
- The ORSA,
 - does not require an undertaking to develop an internal model
 - is not a capital requirement different from SCR and MCR
 - should not be too burdensome

Source: CEIOPS Issues paper Own Risk and Solvency Assessment (ORSA) 27 May 2008

The ORSA is the process that delivers ongoing monitoring and management of the firm's solvency position



From a Pillar III perspective, the ORSA, a component of the SFCR and RTS, can be captured by qualitative and quantitative items



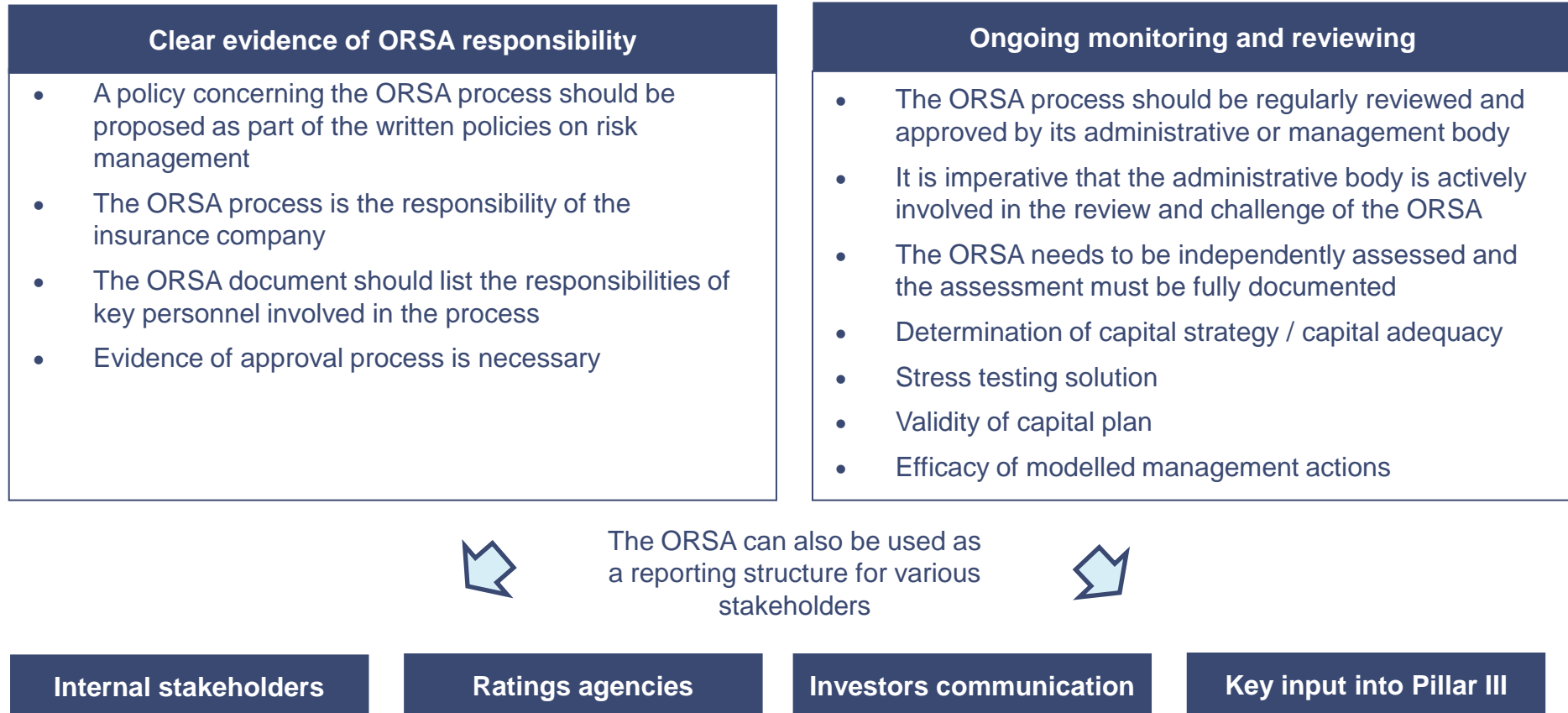
Qualitative disclosure must follow a pre-defined structure

Executive Summary Business and performance A.1 Business and external environment A.1A Objectives and strategies (RTS only) A.2 Performance from underwriting activities A.3 Performance from investment activities A.4 Operating/other expenses A.5 Any other disclosures	System of governance B.1 General governance arrangements B.2 Fit and proper B.3 Risk management system B.4 ORSA B.5 Internal control B.6 Internal audit function B.7 Actuarial function B.8 Outsourcing B.9 Any other disclosures B.10 Reporting at group level (SFCR only)
Risk management C.1 Underwriting risk C.2 Market risk C.3 Credit risk C.4 Liquidity risk C.5 ALM risk C.6 Operational risk C.7 Other material risks C.8 The nature of material risk exposures C.9 The nature of material risk concentrations C.10 Risk mitigation practices C.11 Risk sensitivities C.12 Any other disclosures	Regulatory balance sheet D.1 Assets D.2 Technical provisions D.3 Other liabilities D.4 Any other disclosures
Capital management E.1 Own funds E.2 Minimum capital requirement and solvency capital requirement E.3 The option set out in Article 305b used for the calculation of its solvency capital requirement E.4 Differences between the standard formula and any internal models used E.5 Non-compliance with the minimum capital requirement and significant non-compliance with the solvency capital requirement E.6 Any other disclosures Additional disclosures for undertakings with an approved internal model Annex – Quantitative reporting templates Source: CEIOPS Consultation Paper No. 58 paragraphs 3,86 and 3,298	

- The structure of information required in common to two documents with RTS providing an additional level of granularity
- Both documents would need to be produced on a standalone basis as opposed to incorporating cross-references
- Both SFCR and RTS will require significant qualitative disclosure of
 - Governance
 - Risk management and Internal control
 - Capital management including add-ons
 - Internal models
 - Financial information on performance and solvency balance sheet
- Firms need to determine optimal levels of public disclosure which protects commercially sensitive information while meeting supervisory standards on appropriate public disclosure around
 - Internal models
 - Financial information on performance and solvency balance sheet

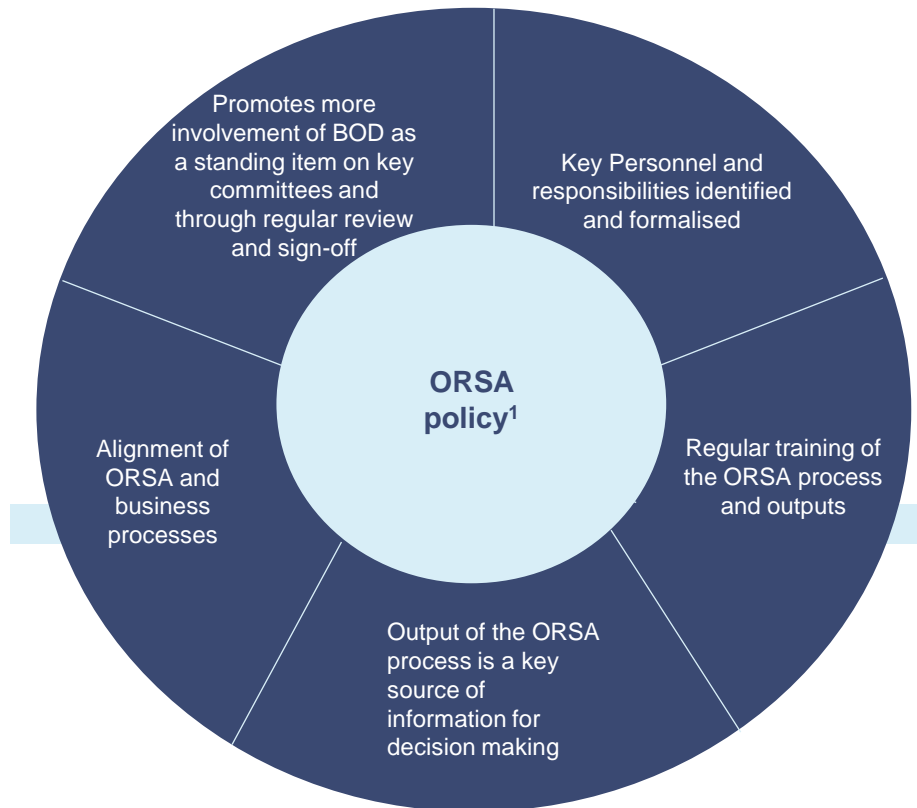
The ORSA process

The overall ORSA process is an opportunity to showcase the firm's overall risk management framework



Integration into management processes

The ORSA should be leveraged in management processes and decision making framework for greatest value



For the ORSA to be fully integrated in the decision processes there needs to be systems and support of the ORSA process.

The ORSA process should be simple and efficient with clear roles and responsibilities.

We believe that the ORSA can add value to the business as a management tool and can be more than just a regulatory requirement.

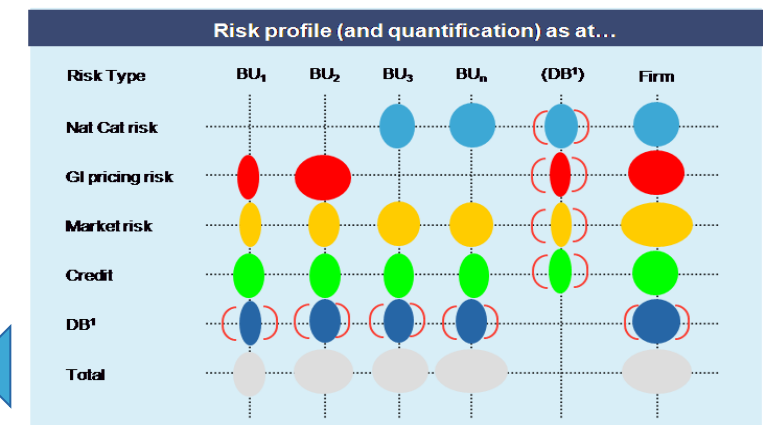
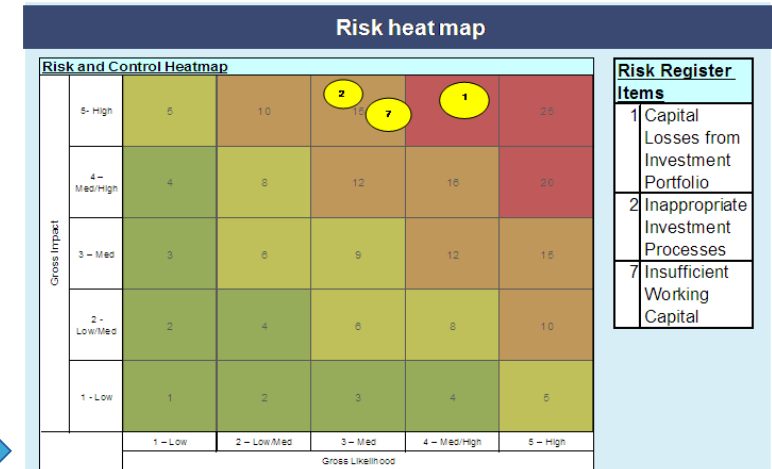
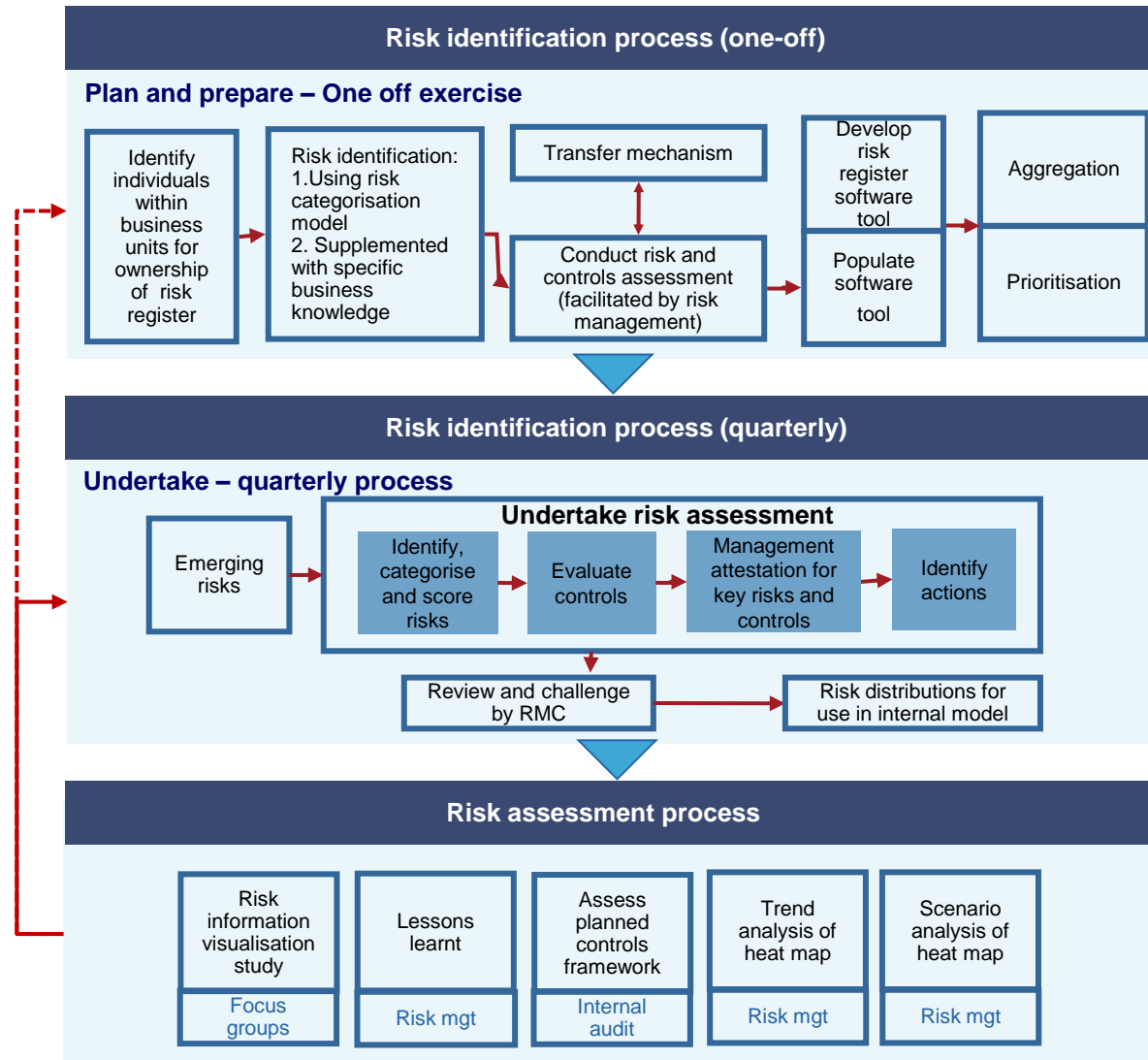
Firms that unlock the value of the ORSA and fully recognise it as management tool will be more successful at integrating the ORSA in their business processes

¹ 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

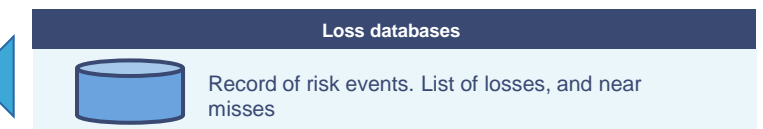
-CEIOPS Issues Paper on ORSA

Risk identification and assessment

Risk identification process should be robust, comprehensive and able to identify emerging and long-term risks

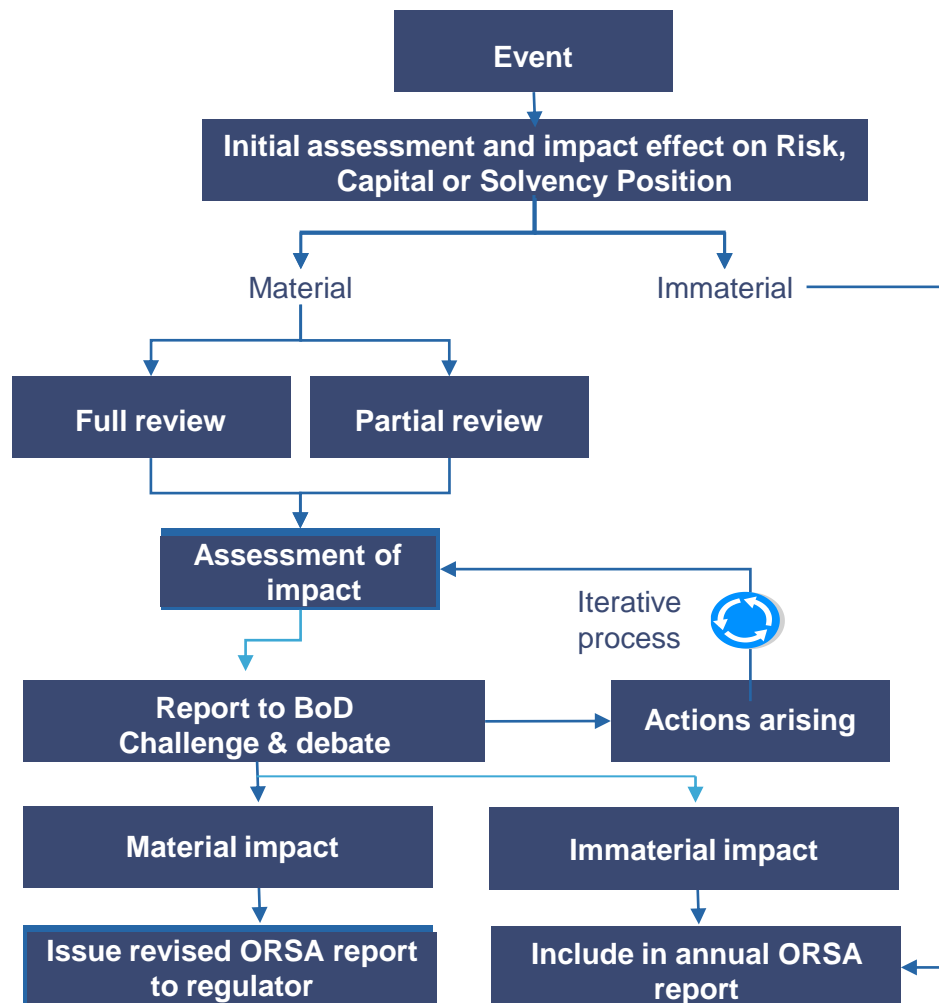


¹Diversification benefit



Ad-hoc ORSA re-runs

Formal presentation of ad-hoc “event-driven” risk, capital and solvency assessments during the reporting period

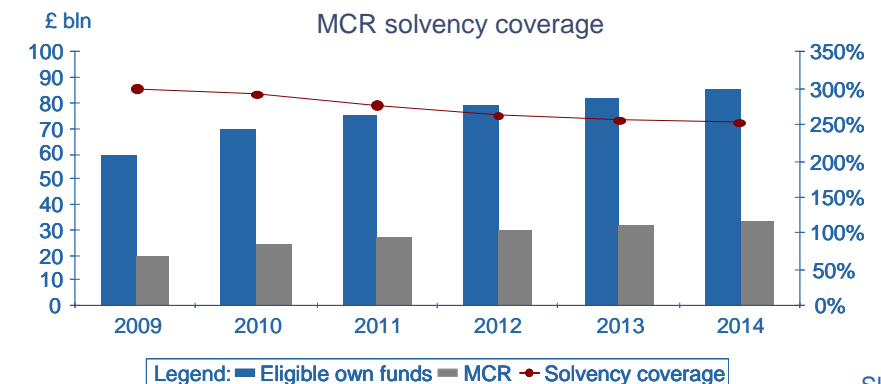
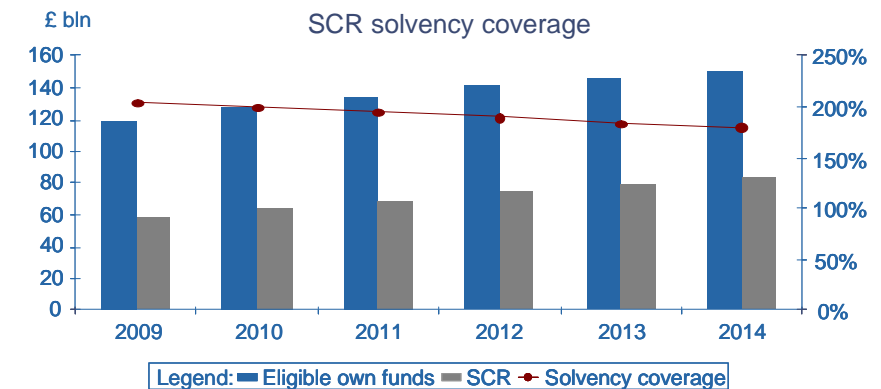
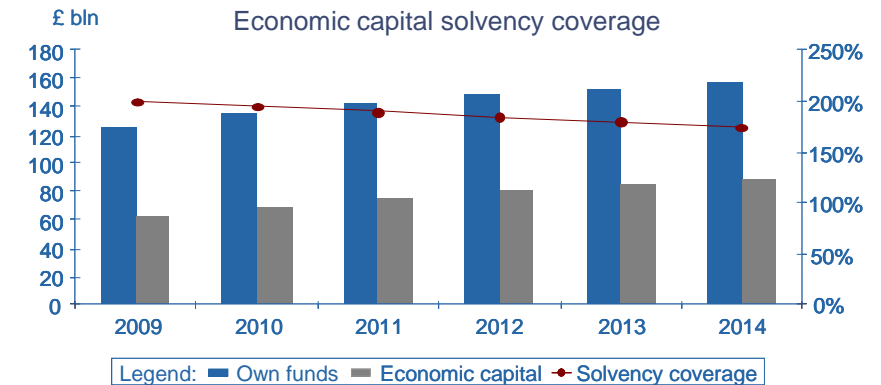


- Frequency of monitoring between ORSA assessments should be associated with
 - the size, volatility and complexity of the risks
 - the frequency of business critical risk based decisions
 - other reporting activities – financial reporting, reserving, market statements, information to rating agencies
 - management and regulatory views
- Firm needs to be in a position where it can assess its risk, capital and solvency position “without delay” following a significant change to its risk profile
- Definition of trigger points based on materiality
- “Event driven” assessments of the firm’s risk, capital and solvency position need not always be ex ante:
 - M&A activity
 - New product launch
- May result in the formal submission of a revised ORSA report to the regulator as part of the normal regulatory supervisory relationship unless in the instances below:
 - M&A opportunity declined
 - Immaterial impact on risk, capital and solvency position
 - Well within defined trigger points
- The regular ORSA report nonetheless provides an opportunity to present a summary:
 - Keeps key stakeholders (regulator, ratings agencies) aware of the firm’s more significant activities
 - Evidences the firm’s risk, capital and solvency management processes and procedures

Forecast capital and solvency position

The firm's projected capital and solvency position over the plan period (3 to 5 year outlook)

- Outline of firm's projected risk, capital and solvency position based on its "base case" plan
 - Planned business volumes (by product, line of business, geography etc)
 - Changes in underwriting strategy (attachment points, terms and conditions, product design, reinsurance/hedging strategy etc)
 - Changes in business model (e.g. outsourcing back / middle office functions leading to a different non financial risk profile)
 - Reflects changes in wider external environment (e.g. macro economic environment, pricing cycle etc)
 - Reflects firm's capital management strategy (dividend vs retained earnings, debt / hybrid maturity profile, own funds & ancillary funds evolution etc)
 - Change in risk profile
- Sensitivity testing / "what if" analysis to assess credibility of projections



Stress and scenario testing

The firm's future capital / solvency position under a number of reasonably plausible (downside) stress tests and / or scenarios

- Results of firm's stress and scenario testing on risk, capital and solvency position
- Combination of single factor stress tests and more comprehensive scenario analysis
- Reasonably plausible stresses and scenarios
 - Recognising firm's risk profile and specific vulnerabilities
 - Can be upside scenarios too (e.g. new business volumes exceeding expectations)
 - In light of current market conditions
 - Cognisant of events / circumstances likely to be of interest to the regulator
- Presented on a pre- and post- management actions basis (allows regulator to assess reasonableness of proposed management actions)



Stress / Scenario-test before mitigation action		Quantitative Impact (£ m)					
Test no. / Description	Qualitative impact	Regulatory Capital			Economic Capital		
		OF ⁽¹⁾	RC ⁽²⁾	SC ⁽³⁾	OF	RC	SC
1. Equity shock	Mark-to-market loss on equity leads to less available capital	-190	-60	-18%	-200	-30	-22%
2. European windstorm	Loss caused by nat cat diminishes available capital	-70	+50	-23%	-120	+55	-24%
3. Major reinsurance failure	Higher required capital due to revaluation of risks	-70	+200	-48%	-60	+300	-44%
4. Lower long-term discount rate (2%)	Higher required capital because of higher discounted cash-flows	+5	+80	-18%	+6	+90	-14%
5. Liquidity crisis	Capital not available in capital markets	-150	+40	-33%	-140	+50	-26%

Stress / Scenario-test after mitigation action		Quantitative Impact (£ m)					
Test no. / Possible mitigation action		Regulatory Capital			Economic Capital		
		OF	RC	SC	OF	RC	SC
1. A. Unwind equity portfolio ('stop-loss')	B. Capital injection	-190	-120	0%	-200	-130	-4%
2. A. Exposure capped through reinsurance		-25	+50	-16%	-40	+55	-14%
3. A. Buy CDS protection	B. Issue catastrophe bond (as an alternative to reinsurance)	-70	+30	-19%	-60	+50	-16%
4. A. Change product mix to focus on quality	B. Tighten limits, cut-offs and underwriting policies	+5	+15	-3%	+6	+20	-3%
5. A. Reduce dividends and defer coupon payments	B. Reduce policyholders bonuses	-35	+40	-15%	-30	+50	-12%
	C. Cancel planned acquisitions						

(1) OF: Own Funds (2) RC: Required Capital (3) SC: Solvency Coverage

Capital plan

The firm's capital plan under the base case and under stress tests / scenarios

Capital position & headroom

- Outline of firm's current capital position (including headroom⁽¹⁾)
- Demonstrate capital flexibility

Instruments Tier 1	OF ⁽²⁾ (£ bln)	Headroom	
Common share	5	Unlimited ¹⁾	
Retained earnings	4		
12-year non-cumulative fixed-term preference shares, maturity in 2014	2		
Total	11		
Instruments Tier 2			
6-year cumulative preference shares, maturity in 2013	3	£5 bln ⁽⁴⁾	
7-year fixed term subordinated liabilities, maturity in 2012	3		
Unpaid non-cumulative preference shares	3		
Total	9	£6 bln ⁽⁶⁾	
Instruments Tier 3			
3-year cumulative fixed-term preference shares, maturity in 2011	3		£3 bln ⁽⁵⁾
2-year fixed term subordinated liabilities, maturity in 2010	2		
Unpaid cumulative preference shares	2		
Total	7		
Grand Total (Tier 1 + Tier 2 + Tier 3)	27		

- MCR non-eligible instruments

⁽¹⁾ Headroom represents the amount of additional capital the firm is able to raise without breaching eligibility limits, based on QIS4

⁽²⁾ OF: Own Funds ⁽³⁾ N/A: Not Applicable

⁽⁴⁾ $Tier\ 2_{MCR} \leq Tier\ 1_{MCR}$, $Tier\ X_{MCR}$ being MCR eligible instruments in Tier X (Art. 98, Solvency II Proposal)

⁽⁵⁾ $Tier\ 3_{SCR} \leq \frac{1}{2} * (Tier\ 1_{SCR} + Tier\ 2_{SCR})$

⁽⁶⁾ $Tier\ 2_{SCR} + Tier\ 3_{SCR} \leq 2 * Tier\ 1_{SCR}$

Base case capital plan

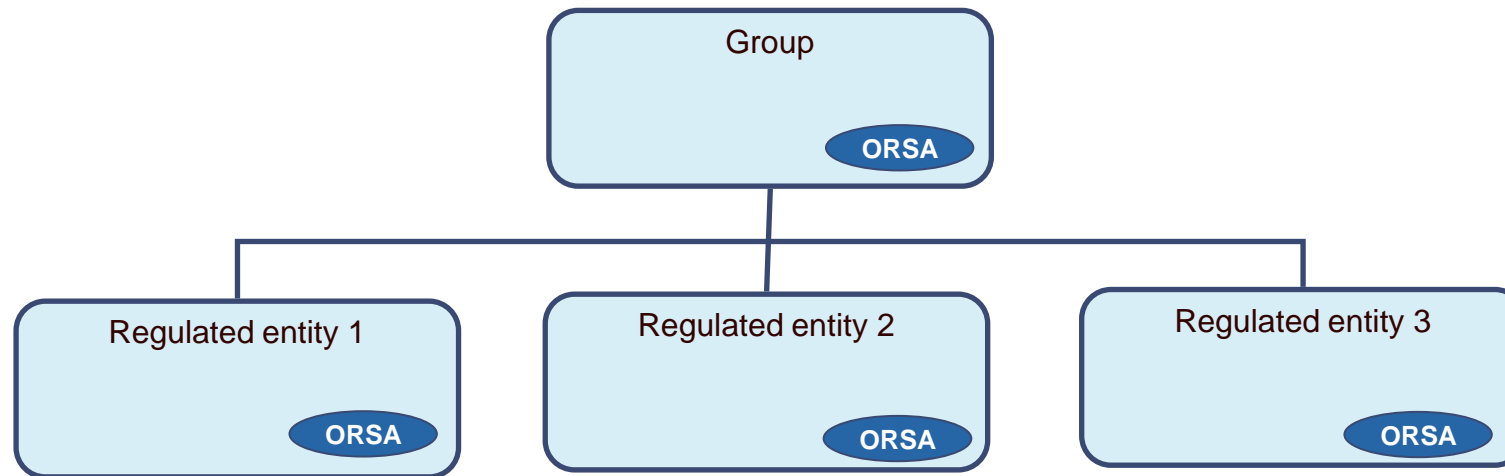
- “Declaration” of capital and solvency strategy (e.g. maintain a solvency margin of between 140 - 150% on an Economic capital basis)
- Outline of firm's capital plan under the base case plan scenario
 - Dividend policy / retained earnings
 - Planned share buy backs
 - Conversion of hybrids
 - Planned Tier 1 capital issuances
 - Maturity/ replacement/ retirement of hybrid/debt instruments
 - Securitisation programme
- Development of headroom following earnings retention/ tier 1 capital issuances

Capital plan under stress

- Capital raising options under stress / scenarios
- Reasonableness of capital plan in the context of stress / scenario
 - Availability of capital
 - Cost of capital
 - Investor reaction
 - Eligibility of funds under stress situation (retrenchment of Tier 1 capital)
 - Debt and banking covenants
 - Contingency plans
 - Prior history / track record of proposed actions

Article 250: Optionality for groups

There is a need to ascertain at which level will the ORSA be documented



Which levels will the ORSA be documented?

Depending on:

1. Participating insurance or reinsurance undertaking or the insurance holding company's decision; and
2. Group supervisor's agreement

ORSA assessments may be undertaken in the following manner:

1. At group level and at the subsidiary levels at the same time; or
2. Produce a single document covering all the assessments

Note:

In submitting a group ORSA, there is an additional requirement for the reconciliation between the group ORSA output to the sum of the solo ORSA of the individual regulated entities

What should be included in the ORSA?



Example of content in a ORSA document

- Summary
- Background
- Purpose and goal
- Responsibility
- Financial situation and Solvency capital situation
 - Current situation
 - > Market situation
 - > Other larger planned changes within the next year (organisation, legal structure, owners etc.)
 - Historic situation (numbers)
 - > Mother company
 - > Subsidiary X, Subsidiary Y, Subsidiary Z
 - Business plan 2012-2014 (numbers)
 - > Mother company
 - > Subsidiary X, Subsidiary Y, Subsidiary Z
 - > Group level

Example of content in a ORSA document (cont'd)

- Risk- and Solvency Assessment
 - Approach and Method
 - Time period
 - Risk identification and self assessment
 - Description of material risks (including risk definition, risk management, risk quantification and capital tied up by the risk)
 - > Market risk
 - > Insurance risk
 - > Counterparty default risk
 - > Operational risk
 - > Liquidity risk
 - > Strategic risk
 - > Reputation risk
 - Capital situation (MCR, SCR, ORSA result and own funds (capital base))

Example of content in a ORSA document (cont'd)

- Risk management (description of organisation, responsibilities etc)
- Description of risk tolerance and risk appetite
- Stress tests and scenario analysis
 - Mother company
 - > Weak recession, strong recession etc.
 - Subsidiary X, Subsidiary Y, Subsidiary Z
 - > Weak recession, strong recession etc.
 - Group level
- Usage of the own risk and solvency assessment in the company
- Quality control and approval of the ORSA
- Future developments
- Appendix – Reference documents (incl. Board minutes)

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