Solvency II—Implementing ORSA for Pillar 2 Requirements

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The current Solvency I regulation is based on a simple and formula-based approach, which requires insurers to maintain a required level of solvency margin to cover technical provisions. This approach lacks the overall analysis of financial strength and stability because of its limited coverage of risk management.

For that reason, Pillar 2 of Solvency II explicitly focuses on establishing a robust risk management framework to ensure the capital adequacy of insurers. This holistic overview on risks also covers the Own Risk and Solvency Assessment (ORSA), which is mandatory for every insurer. It requires insurers and re-insurers to establish their own ORSA process to conduct the overall solvency needs assessment related to their specific risk profile.

Insurers, with their own sets of business, products and geographical presence, are exposed to different levels and kinds of risks. Risk profiling will be one of the key tasks when determining the overall solvency needs. Once risk profiling is completed, insurers need to define their acceptable maximum aggregated level of risks and variations on the different risk factors. ORSA should take into account a forward-looking approach that takes into account the insurer’s future business plans and projections. Changes in the risk profile of the firms will have an impact on overall solvency needs.

The purpose of this paper is to help insurers define their ORSA process aligned with regulatory guidelines. It is also designed to help interpret ORSA guidelines to gain insight of the European Insurance and Occupational Pensions Authority (EIOPA) consultation paper. There are concerns about implementation of these guidelines but a focused and comprehensive approach to overall risk management and governance framework will establish a series of successful outcomes that will benefit organizations in the long term.
Introduction

On November 7, 2011, EIOPA published a consultation paper on ORSA with an updated set of guidelines, which broaden Article 45 & 246(4) of Solvency II Directive 2009/138/EC. ORSA connects the quantitative requirements of Pillar I with the risk management requirements of Pillar II by requiring firms to assess their capital and solvency needs.

The primary purpose of ORSA is to ensure that the firm assesses all risks inherent in its business and determines its corresponding capital needs. Firms are obliged to append the findings in their regular strategic and operational decisions for better risk management. Though the voting of the European Parliament on the final version of the Omnibus II directive has been rescheduled for October 2012, no material changes are expected in ORSA guidelines.

Key Elements of ORSA Requirements

The consultation paper from EIOPA sets out ORSA guidelines focuses on the outcome of the ORSA process rather than its method of performance. It indicates that during its overall solvency assessment, a firm needs to decide how it wants to run its ORSA processes through consideration of nature, scale and complexity of risks inherent to its business. Firms should ensure that ORSA is reflected as a process rather than a reporting requirement.

This consultation paper can be classified into the following broad categories:

**Principle of Proportionality**
As a part of ORSA, firms should develop and implement appropriate and adequate techniques/processes for identifying, assessing and quantifying risks. All should fit into the organizational structure, governance and risk management systems. Among the risks that should be considered are underwriting, market, counterparty default, operational, intangible assets and other specific risks to each insurer. These include liquidity, business, strategy and reputation.

**Role of the Administrative, Management or Supervisory Body**
Administrative, Management or Supervisory Body (AMSB) should actively participate in the ORSA process by directing assessment performance. AMSB should challenge identification and assessment of risks and process outcomes before accepting the ORSA report.

The firm should embed results and outcome of the ORSA into capital management, business planning, strategic decisions and product development.

**Regulatory Capital Requirements and Technical Provision**
ORSA should include procedures and processes to enable the firm to regularly and reliably monitor its compliance with regulatory capital requirements while monitoring and managing its own funds. Whenever the firm’s risk profile significantly changes, a full calculation of Solvency Capital Requirement (SCR) is also required.

The firm should ensure during the ORSA process that the actuarial function provides input for continuous compliance with the calculation of technical provisions and risks arising from this calculation.

**Assessment of the Overall Solvency Needs**
The firm should address overall solvency needs in quantitative terms and complement it with a qualitative description of risks.
**Addressing the Challenge**

There may be uncertainty about ORSAs comprehensive view and its complexity. ORSA is meant to identify, assess, monitor and report all risks which are inherent to a business. Each firm should design and define its ORSA in relation to the size and culture of the organization.

ORSA also paves the way to determine funding for maintaining the regulatory solvency status. One challenge for insurers is the ORSA requirement for the performance of scenario analysis and stress tests because these activities are requisites for the assessment of overall solvency needs. Establishing defined risk appetite as a part of the firm’s overall risk management framework, considered an ORSA process benchmark, is another challenge. Most ORSA components are already present in the existing risk management system but all these components have to be integrated and embedded into the formal process.

A risk appetite framework states the methodology through which a firm defines the risks to acquire, avoid and retain in alignment with its business strategy. Communication of the ORSA process and findings to internal stakeholders and external parties is required by guidelines. The firm should pay close attention to implementing the appropriate communications channel.

Solvency II will enforce a significant change in existing processes and practices, which will require a corresponding change in the behavior and attitude of the entire firm. These behavioral changes will lead to a shift in the firm’s organizational culture. Each firm will need to identify its capability to run the ORSA exercise and ensure sufficient resources to complete it. If the firm does not have sufficient resources available in-house, it may be necessary to recruit and retain skilled resources for ORSA.

**Develop a Strategy**

To run an ORSA process effectively, firms need to undertake a detailed assessment of their resources’ understanding, existing systems and skill sets. Joint collaborative efforts from different functions including risk management and actuarial are keys to successful ORSA implementation. The combination of the two functions facilitates implementation of the risk-management system within the ORSA process.

Role of the administrative, management or supervisory body (AMSB) should be adequately defined and documented to ensure its active and vigilant participation in the ORSA process. AMSB should include the outcome of this exercise in its regular strategic decisions.

To validate the specific methods and techniques applied for this exercise, firms have to conduct risk profiling, risk quantification and a wide range of stress tests and scenario analysis for their internal model. Development of risk data repositories will enhance firms’ ability to classify exposures to credit risk, market risk and operational risk. To get relevant results, firms require drilled-down assessments at different confidence levels and will need to take longer term considerations into account.
Risk management and governance practice should be embedded in the organizational culture. Determining the risk appetite of the business will be required to reflect the insurer’s operations and must be documented and circulated for better understanding and decision making. Risk and solvency-related information should be available to all key stakeholders on a regular basis. Insurers will have to carve out their business strategies to maximize the overall return with their defined level of risk appetite.

Considering the complexity and volume of effort required for an ORSA process, firms will have to analyze and recognize how to prepare and chart the plan for this exercise.

**Conclusion**

Omnibus II is scheduled to be presented in October 2012, which will pave the way to infuse the pace of ORSA preparations. There are insurers who have already started basic preparations to run the exercise independently. ORSA should not be considered as a stand-alone process but an overall risk management function that should be integrated with other processes and activities of insurers.

Developing an Enterprise Risk Management (ERM) framework to understand risks will be required to cope with Solvency II requirements. Embedding ERM into the culture of an organization will not be easy but it offers a competitive advantage. The implementation of a sound ERM framework will result into the equally successful implementation of ORSA requirements through a meaningful and thorough risk management approach.

As ORSA implementation spans disparate insurer functions, collaboration by all departments is essential for successful completion. Once Omnibus II is presented and adopted, there will be more clarity on requirements at a granular level.

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Syntel provides custom outsourcing solutions to Global 2000 corporations. Founded in 1980, Syntel’s portfolio of services includes BPO, complex application development, management, product engineering, and enterprise application integration services, as well as cloud computing, e-Business development and integration, wireless solutions, data warehousing, CRM, and ERP.

We maximize outsourcing investments through an onsite/offshore Global Delivery Service, increasing the efficiency of how complex projects are delivered. Syntel’s global approach also makes a significant and positive impact on speed-to-market, budgets, and quality. We deploy a custom delivery model that is a seamless extension of your organization to fit your business goals and a proprietary knowledge transfer methodology to guarantee knowledge continuity.

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**REFERENCES**

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