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EIOPA's Supervisory Assessment of the Own Risk and Solvency Assessment - First experiences -

EIOPA – Westhafen Tower, Westhafenplatz 1 - 60327 Frankfurt – Germany - Tel. + 49 69-951119-20;

Fax. + 49 69-951119-19; email: info@eiopa.europa.eu site: www.eiopa.europa.eu

Executive Summary

This report outlines the EIOPA's analysis of the first supervisory experiences regarding the application of the regulation on the Own Risk and Solvency Assessment (ORSA) by (re)insurance undertakings. This assessment is part of the undertakings' risk management and regulated by Article 45 of the Solvency II Directive.

EIOPA's analysis is based on the observations collected by the National Supervisory Authorities (NSAs) in the European Economic Area (EEA) up to the end of 2016. The key findings can be summarised as follows:

- **The majority of (re)insurance undertakings have made good progress in implementing the ORSA process:** ORSA processes including the involvement of key function holders are implemented adequately by the majority of (re)insurance undertakings. However, EIOPA encourages especially small undertakings to further elaborate on the ORSA process including their ORSA policy and the quality of data used in the assessments.

- **The need for a greater involvement of the administrative, management or supervisory bodies:** EIOPA encourages undertakings to improve the involvement of their administrative, management or supervisory bodies (AMSB) in the ORSA process. Board members are expected to follow the top-down approach and to play an active role in the ORSA assessment. EIOPA expects AMSB members to use the ORSA results in their strategic decision-making process to enhance the overall risk management of the undertaking.

- **The scope of risk assessment to be further expanded:** According to ORSA requirements undertakings should assess all current or potential material risks, including those that are not quantifiable. The findings show that risk assessments do not always include all potential risks and, in many cases is not linked to the business model and strategic management actions of the undertaking. Therefore, EIOPA recommends undertakings to widen the scope of their risk assessment and to deepen the risks analysis.

- **Overreliance on the standard formula by undertakings:** The assessment of the significance with which their risk profiles deviate from the assumptions underlying the solvency capital requirement under the standard formula should be further improved. EIOPA expects all undertakings to perform an assessment of their specific risk profile when calculating their overall solvency needs, taking into account the proportionality principle.

- **The quality of stress testing including reverse stress tests and scenarios used in the ORSA assessments to be further improved:** The stresses used should enable undertakings to evaluate appropriately in a forward-looking perspective the potential risks they and their business may be exposed to and the required solvency in order to manage such risks. EIOPA encourages undertakings to further improve the quality of stress testing.

1. Introduction

Article 45 of the Solvency II Directive requires every (re)insurance undertaking in Europe to conduct its Own Risk Solvency Assessment (ORSA). EIOPA issued preliminary Guidelines for the preparatory phase towards Solvency II at end-2014[1] and the current Guidelines[2] in 2015.

EIOPA's overall objective is to achieve a high, effective and consistent level of regulation and national supervision to enhance supervisory convergence across the European Union.

EIOPA's analysis is based on the active dialogue with the National Supervisory Authorities from each European Union Member State, as well as Iceland, Liechtenstein and Norway. It provides a first insight into the national experiences with the supervisory assessment of the ORSA under the new Solvency II framework, including areas for further improvements.

(Re)insurance undertakings are at an early stage in the application of Solvency II requirements into daily business. EIOPA encourages undertakings to assess their own ORSA processes and reports with regard to the identified areas for improvement.

EIOPA also analysed and continues to monitor the feedback given by the National Supervisory Authorities to the supervised undertakings regarding their performance of ORSA.

This report is structured as follows:

- Section 2 presents the areas for improvement from the assessment of ORSA reports.
- Section 3 describes the feedback given by the National Supervisory Authorities to the supervised undertakings.

2. Areas for Improvement in the ORSA Reports

2.1. ORSA Process including the involvement of Key Functions

Good progress has been made in implementing the ORSA processes and ORSA policy by most undertakings. Over the last years the vast majority of undertakings have established well-functioning internal processes allowing key function holders to be involved and take responsibility for the conduct of ORSA.

EIOPA has monitored that small insurance undertakings face more challenges in implementing and applying ORSA processes for example with regard to appropriate

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[1] See https://eiopa.europa.eu/Publications/Consultations/EIOPA-13-414_Final_Report_on_CP09.pdf

[2] See https://eiopa.europa.eu/publications/eiopa-guidelines/guidelines-on-own-risk-solvency-assessment-(orsa)

ORSA policies and procedures and the quality and appropriateness of data used in the ORSA assessment.

2.2. Involvement of the AMSB and Embedding ORSA Results in Strategic Management Decisions

Members of the administrative, management or supervisory bodies (AMSB) seem not to be fully involved and thus do not challenge crucial parts of the ORSA process. This has an impact on the ORSA results such as the risk assessment or the use of methodology including stress and scenario tests.

Most undertakings apply an appropriate forward-looking perspective and time horizon in their ORSA assessments, in particular regarding the assessment of their overall solvency needs. However, strategic management decisions taken by majority of AMSB members of insurance undertakings in Europe are missing the reflection of ORSA results. ORSA results are not yet properly embedded in the decision-making processes. The current stage of implementation does not meet the relevant requirements[3] and further improvements are needed.

EIOPA invites undertakings to improve the involvement of AMSB members in the ORSA process and to better reflect and embed ORSA results in strategic management decisions.

2.3. Risk Assessment of All Material Risks

Another major area for improvement in the ORSA is the undertaking’s risk assessment of all material risks the respective undertaking is or could be exposed to including non-quantifiable risks. The undertaking's risk assessment process is the basis for all three assessments set out in Article 45(1) of the Solvency II Directive[4].

EIOPA highlights the importance of the undertaking’s business plan analysis for performing an appropriate risk assessment, the fact that the evaluations of the overall solvency needs and capital requirement on continuous basis are based on material risks identified in the risk assessment and that identified material risks can be covered by capital and by other means in the overall solvency needs assessment.

The ORSA risk assessment is the undertaking’s own risk assessment. Therefore, EIOPA encourages undertakings to use their own risk categories or types based on the characteristic of the specific undertaking, its business model and risk profile and not only on the standard classification of the Solvency II Directive. In the ORSA, the undertaking needs to assess all material risks from a complete perspective including an economic and a regulatory perspective, and with regard to both non-quantifiable

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[3] See Article 45(4) of the Solvency II Directive as well as EIOPA Guideline 2 on own risk and solvency assessment.

[4] These are the overall solvency needs, the compliance, on a continuous basis, with the capital requirements and the significance with which the risk profile of the undertaking concerned deviates from the assumptions underlying the Solvency Capital Requirement.

and quantifiable risks. It is important to assess more closely operational, emerging and potential cyber risks at an appropriate level of rigour. Improving the quality of the risk assessment requires taking into account all potential risks. The objective of the ORSA is a significantly deepened understanding of the undertaking's risk profile from the perspective of its ongoing viability. In case ORSA results show potential danger to the viability of the undertaking's business, EIOPA strongly recommends undertakings to define management actions within ORSA.

The ORSA risk assessment performed by insurance groups requires further improvement as regards group specific risks. For example risks related to intra-group transactions or the interconnection of entities. EIOPA encourages insurance groups to assess more appropriately whether their risk assessment reflects potential risks stemming from the structure of the group. Those risks could arise for example through the presence of (intermediary) holding companies or non-insurance undertakings, including proper identification, assessment of materiality of those risks and, when considered non-material, whether this conclusion was properly justified.

In case the group entity designs the ORSA process for the entire group (for example for a cross-border group), material risks at local entity level are not always appropriately reflected in the solo ORSA reports. Therefore in EIOPA's view solo entities in a group structure should adopt their own ORSA process in order to properly reflect all relevant specifics of the solo entity, for example regarding its business model, characteristics of the insurance market in which the entity operates, individual risk profile of the undertaking. As a part of their solo ORSA, all risks specific to the local entity should be assessed regardless of the fact that these risks are relevant or material at the level of the group or not.

2.4. The Standard Formula and ORSA

It is crucial to understand for each (re)insurance undertaking how its specific risk profile deviates from the assumptions made for the standard formula. The quality of an undertaking's assessment of the significance with which its risk profile deviates from the assumptions underlying the Solvency Capital Requirements under the standard formula[5] requires further improvements. National Supervisory Authorities throughout Europe pointed out that some ORSA reports submitted are missing this ORSA assessment.

The standard formula is a model based on a hypothetical, average undertaking and so EIOPA expects every undertaking to deviate on a minor and/or major level from the assumptions made for the standard formula. The undertakings' own assessment in the ORSA, which should result in an understanding if such deviations are significant or not, is required. This assessment helps undertakings to define an appropriate view on their calculation of their overall solvency needs. EIOPA observed cases showing an overreliance on the standard formula by undertakings when calculating their overall

[5] See Article 45(1c) of the Solvency II Directive

solvency needs. EIOPA views an automatic reliance on the standard formula as inappropriate for the purposes of the ORSA.

Assessing the significant deviations of the undertaking's risk profile from the assumptions underlying SCR, undertakings should consider all material quantifiable risks covered by the standard formula for SCR calculation taking into account the risk profile of the undertaking. Undertakings are expected to perform at least a qualitative assessment of the deviation of their risk profile from the assumptions underlying the SCR calculation. In case that this deviation is significant, EIOPA expects undertakings to report the estimation of this deviation and its impact on their capital needs in the ORSA reports.

Undertakings could question if this approach might lead them to develop a (partial) internal model in the case of major deviations reported. It should be stressed that the aim of the ORSA is to enhance the risk management of the undertaking.

The application of materiality and proportionality does not exempt undertakings, regardless of using the standard formula or an internal model, to appropriately perform the ORSA. Even in cases where the nature of the business model, risk profile and the proportionality principle are adequately taken into account, undertakings are expected to always have as starting point their own assessment of the specific risk profile. EIOPA underlines the neccessity to use own methods by all undertakings in the overall solvency needs calculation and, taking into account the proportionality principle, supports smaller undertakings with less complex risk profiles to apply them even with a limited scope. Those undertakings could for example base their own method only on most material risk modules or on estimations.

2.5. Quality of Stress Testing

Stress tests should be applied to determine the undertaking's overall capital needs. When choosing the stress tests scenarios, it is important to consider inter alia the following criteria:

- The stress tests applied reflect the risk profile of the undertaking taking into account its risk appetite.
- The realisation of several major events happening at the same time is appropriately considered.
- Future possible management actions are realistically considered. The severity of the assumptions applied and variety and reliability of the scenarios are appropriate for the undertaking's risk profile.`

EIOPA stresses the potential need for improvement in the quality of stresses including reverse stress tests and scenarios used in the ORSA assessments. Furthermore, in EIOPA's view stress tests or scenario analyses used in ORSA should challenge the solvency position of the undertaking by identifying key vulnerabilities to risks and key risk drivers or other important variables (for example expected future business results).

In cases where undertakings use stress tests and scenario analysis only in a very limited way in their ORSAs, the ability to evaluate appropriately in a forward-looking perspective the potential risks the undertaking and its related business may be exposed to and the required solvency to cover such risks is limited.

However, taking into account the proportionality principle the complexity of the stress tests and scenario analyses performed in the ORSA could vary between undertakings. Undertakings with a less complex risk profile may choose only key risks for stress tests and/or may apply simplified methods. EIOPA encourages undertakings to use different types of stress tests and reverse stress tests, taking into account extraordinary, but plausible as well as emerging scenarios. Reverse stress testing could be another example of analysis performed by starting with the outcome of a business failure, and then analysing different scenarios under which such failure may occur. According to EIOPA's opinion the use of reverse stress testing is a good practice in the ORSA. Taking into account the proportionality principle EIOPA encourages undertakings to use this approach even in a limited way (for example based on estimations or qualitative experts' judgement) in their ORSA.

In case of applying long-term guarantee (LTG) measures and transitionals, the assessment of continuous compliance with regulatory capital requirements and technical provisions need to report ORSA results which are calculated with and without those measures. Small undertakings with less complex risk profiles are not required to stress the continuous compliance separately for each LTG measure and transitionals used, but only for those measures which have a major impact on the SCR of the undertaking.

3. NSAs' Feedback to Industry

The feedback from National Supervisory Authorities (NSAs) regarding the quality of ORSA varies across Europe. In general, NSAs provide feedback to undertakings and request further discussions with the undertaking regarding their ORSA.

When providing feedback to undertakings NSAs elaborate and take into account the specificities of the national insurance market and any other national issues. EIOPA expects undertakings, which are subject to a closer and more engaged supervision, receive proportionately more granular, i.e. more individual, feedback on the quality of their ORSA.

3.1. Individual Feedback

Out of 31 National Supervisory Authorities 23 had provided individual feedback to undertakings by the end of 2016.

The format of the individual feedback varies and is given as oral feedback (for example during meetings with the AMSB or during on-site inspections or by via telephone calls with the key function holder responsible for the ORSA) or in writing to the respective undertaking.

3.2. Public Feedback

Out of 31 National Supervisory Authorities 20 had provided public feedback to the insurance sector about the quality of ORSA reports received by the end of 2016.

Public feedback could be given by way of supervisory letters to all supervised undertakings or published on the respective National Supervisory Authority's website or in form of public discussions. Those discussions could be held in forums, panels, seminars or workshops. Discussions with industry associations are included here as well.

Out of 31 National Supervisory Authorities 18 had chosen a combination of individual and public feedback to undertakings by the end of 2016.