Society of Actuaries in Ireland

Solvency II: Introduction to Pillar 2

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Agenda

- What is Pillar 2?
- Overview of the System of Governance requirements
- CBI Domestic Actuarial Regime (CP92)
- What is an ORSA?
- Overview of the ORSA requirements?
- ORSA Challenges

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The Regulatory Requirements

The main sources of the System of Governance requirements are:

- Solvency II Directive (Articles 41 to 49)
- Delegated Acts (Articles 258 to 261 and 266 to 275)
- EIOPA Level 3 Guidelines on System of Governance
- Domestic Actuarial Regime and Related Governance Requirements under Solvency II published by the CBI

What is Pillar 2?

Two key concepts

1 System of Governance

Robust governance is a pre-requisite for an efficient solvency system. Undertakings must comply with the requirements on fit and proper, risk management, the ORSA, internal control, internal audit, the actuarial function and outsourcing.

In particular, the underlying objective of the ORSA is to ensure:

- they identify and assess all risks they are (or could be) exposed to;
- they maintain sufficient capital to face these risks; and
- they develop and better use risk management techniques in monitoring and managing these risks.

2 Supervisory Authorities and General Rules:

- supervisors shall be responsible for evaluating how undertakings are assessing their capital adequacy needs relative to their risks (i.e. the *Supervisory Review Process*).
- To perform this role, they are empowered to require remedial actions when capital does not seem to be adequate.

Pillar 2

Qualitative Requirements and Rules on Supervision

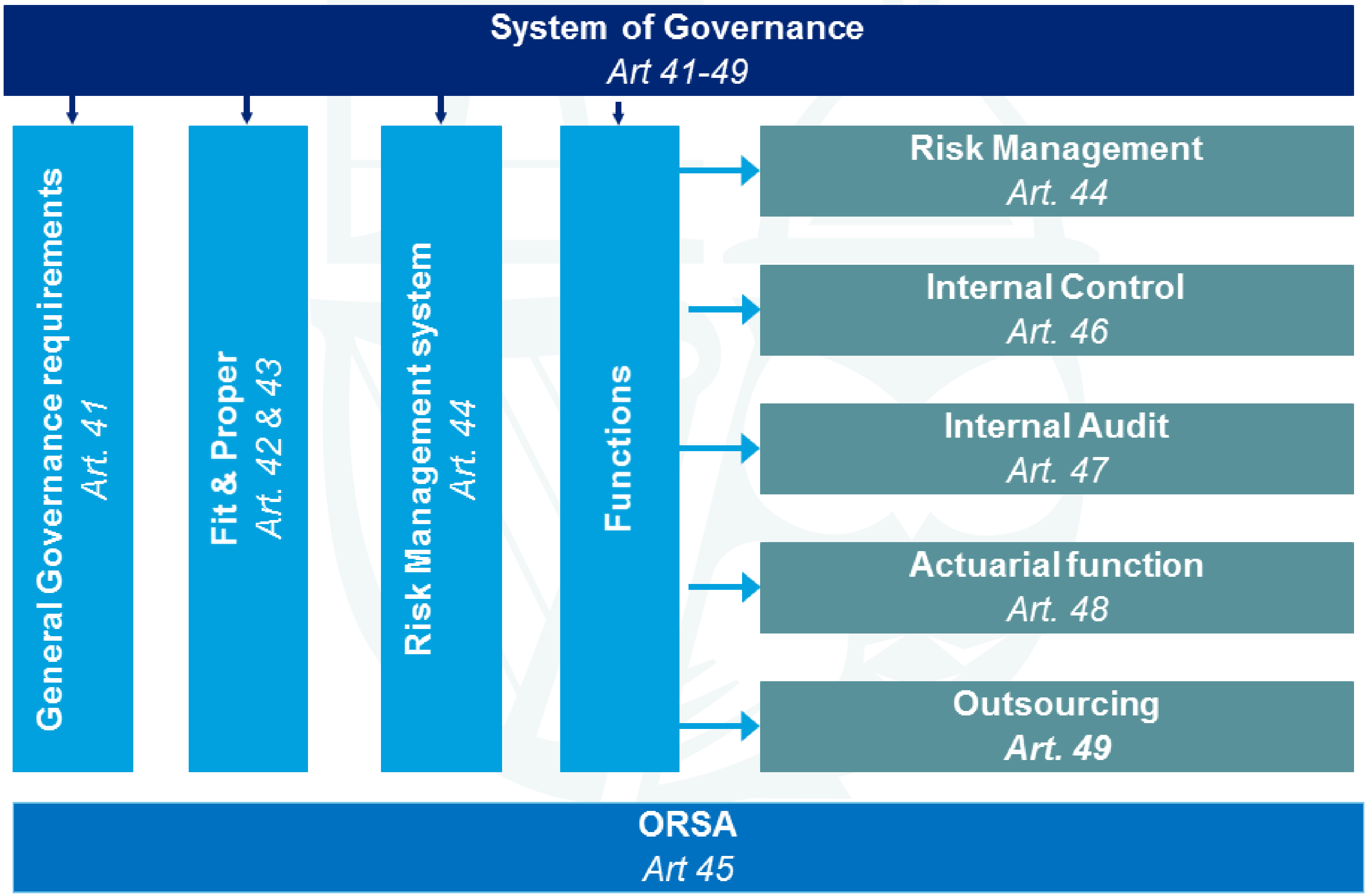
Own Risk and Solvency Assessment (ORSA)

Capabilities and powers of regulators, areas of activity

Governance

Overview of the System of Governance requirements

Overview of the Level 1 Directive articles related to System of Governance



Overview of the System of Governance requirements

General Governance Requirements (Art. 41)

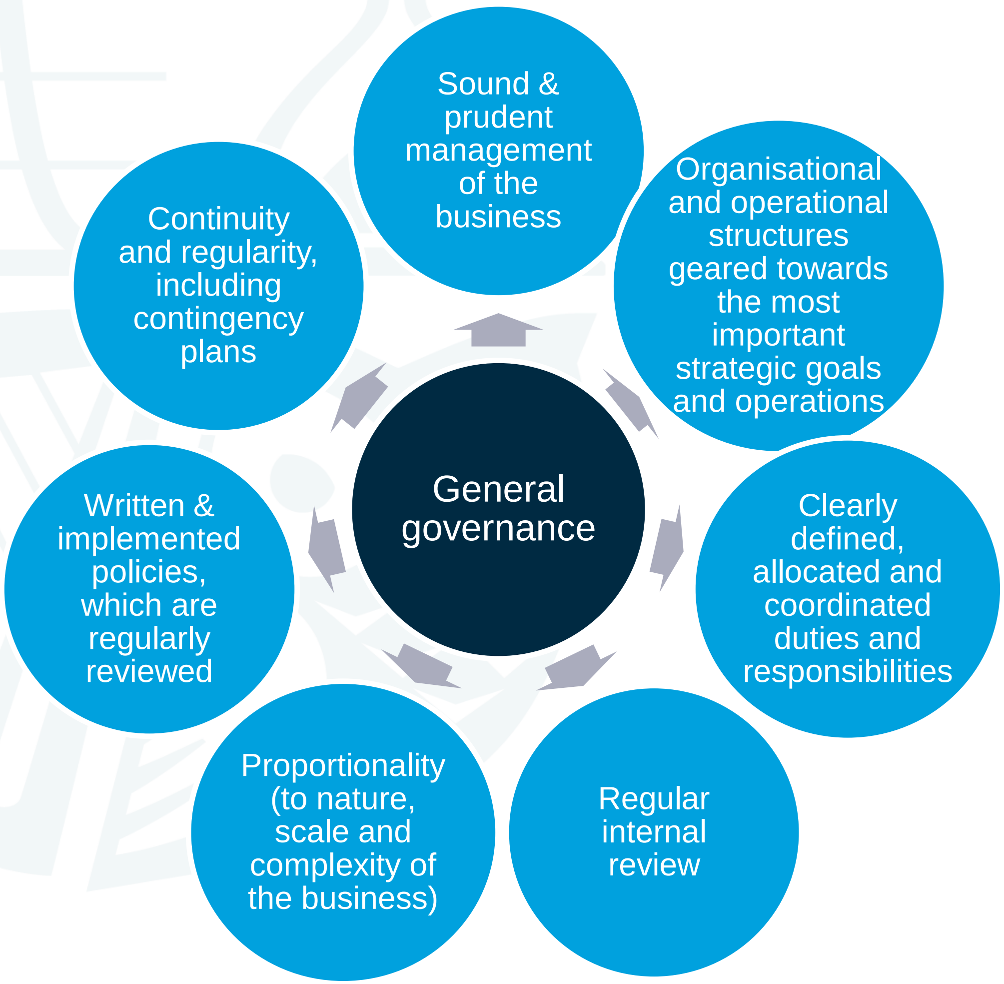
Overview

Within a Solvency II compliant (re)insurance company, **general governance must ensure all goals** depicted in the figure on the right hand side are met.

Reporting

On a periodical basis the (re)insurance company must **inform** its stakeholders on the **status of the system of governance** in the:

- Regular Supervisory Report (“RSR”);
- ORSA Supervisory Report;
- Solvency and Financial Condition Report (“SFCR”).



Overview of the System of Governance requirements

Fit & Proper (Art. 42 & 43)

Overview

(Re)insurance companies must have policies and procedures in place to ensure that all persons who effectively run the undertaking or are responsible for other key functions are at all times fit and proper.

The **fit & proper policy** should at least include a description of:

- the procedure for **notifying** the supervisor when the company outsources a key function or changes to identity;
- the procedure for **assessing** the fitness and probity of persons who are effectively **running** the undertaking or have a **key function**, both initially and on an on-going basis;
- the minimum situations that give rise to a **re-assessment** of fitness and probity;
- the procedure for **assessing** the fitness and probity of **other personnel**, both initially and on an on-going basis.

When a key function is outsourced, the fitness and probity requirements **apply to the person so employed**.

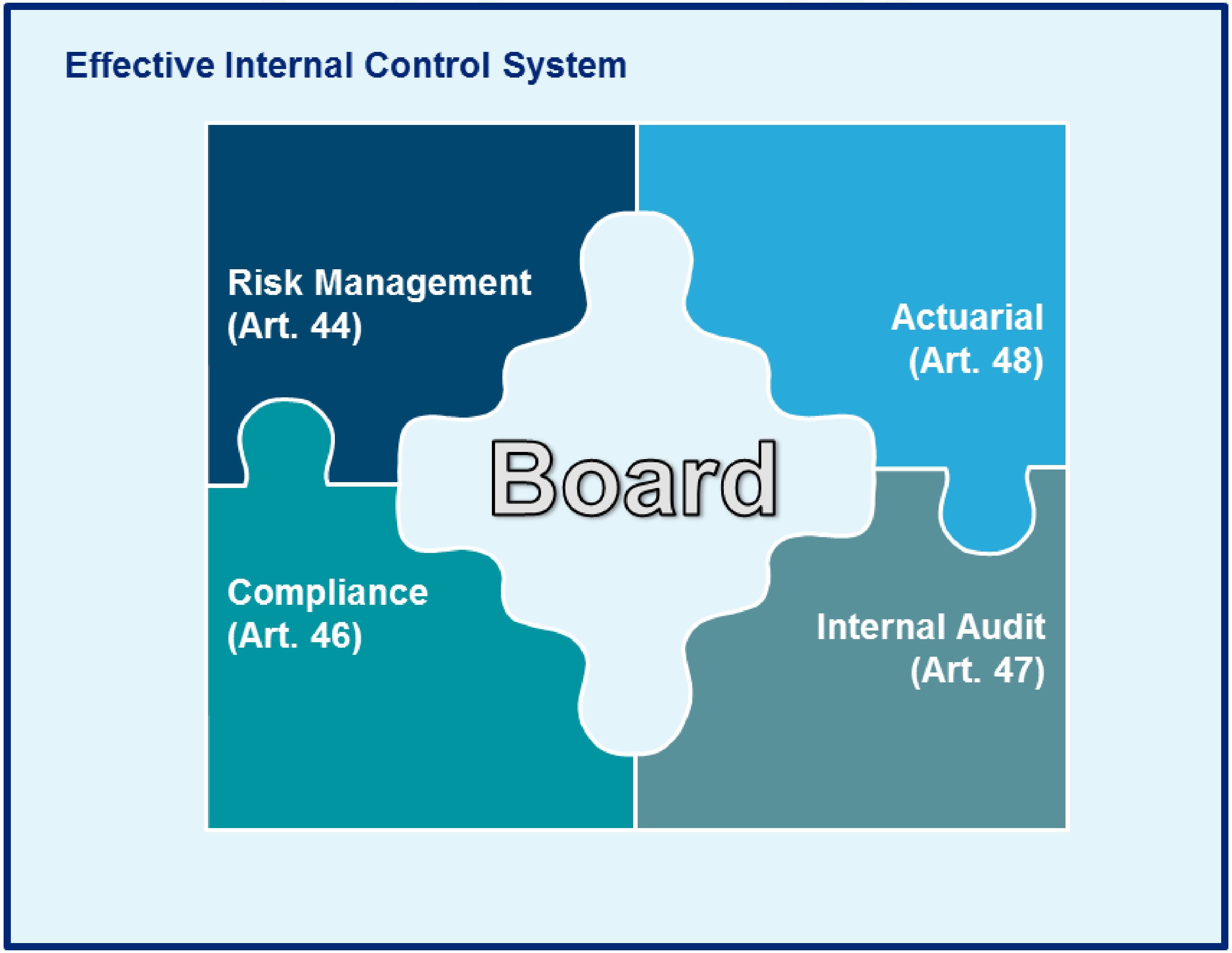
Administrative, Management or Supervisory Body ("AMSB")

The collective knowledge, competence and experience of the **Board** should at a minimum include:

- Market knowledge;
- Business strategy and business model;
- System of governance;
- Financial and actuarial analysis; and
- Regulatory framework and requirements.

Overview of the System of Governance requirements

Functions specifically required by Solvency II (Art. 44, 46, 47, 48)



Overview of the System of Governance requirements

Risk Management Function (Art. 44)

Risk Management (Art. 44)

The **Risk Management function** shall:

Put in place strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report on a continuous basis the risks, at an individual and at an aggregated level, to which the company is or could be exposed, and their interdependencies.

The **Risk Management Function** should:

- Assist the Board, management and other functions in the **effective operation of the risk management system.**
- **Monitor** the risk management system.
- Maintain an entity-wide view on the **risk profile of the undertaking.**
- **Report** in detail on risk exposures and advise the Board & management on risk management matters.
- **Identify** and assess emerging risks.
- Regularly **evaluate the design and effectiveness** of the risk management system and report findings.
- Design, implement, test, validate, document the **internal model**.
- Assess the appropriateness of **external credit rating assessments**.
- Cooperate closely with the **actuarial function**.

Overview of the System of Governance requirements

Compliance Function (Art. 46)

Compliance (Art. 46)

The **Compliance Function** shall:

Advise the Board on compliance with the laws, regulations and administrative provisions adopted pursuant to the Solvency II Directive and assess the possible impact of any changes in the legal environment on the operations of the undertaking concerned and the identification and assessment of compliance risk.

The **Compliance Function** is responsible for:

- The **identification and assessment** of compliance risk.
- **Reporting any major problems** identified promptly.
- Contacting any member of staff and **gain access to any records** required to allow it to fulfill its duties.
- Compliance work to be undertaken in the next business year(s) should be set out in a **compliance plan**.
- The compliance plan should ensure that all relevant areas of the entity are appropriately covered, **taking into account their susceptibility to compliance risk**.
- **Promote the importance** of the internal control system and ensure staff are aware of the system and understand their role within it.

Overview of the System of Governance requirements

Internal Audit Function (Art. 47)

The **Internal Audit Function** shall:

Evaluate the adequacy and effectiveness of the internal control system and other elements of the system of governance and report any findings and recommendations to the Board. This function must be objective and independent from the operational functions.

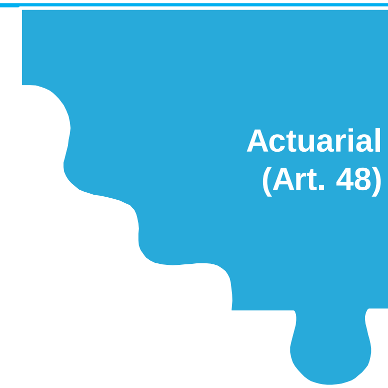
Internal Audit (Art. 47)

The **Internal Audit Function** should:

- **Establish, implement and maintain an audit plan** setting out the audit work to be undertaken in the upcoming years.
- Adopt a **risk-based approach in deciding its priorities.**
- **Report the audit plan** to the Board.
- Submit a **written report on its findings and recommendations in relation to audits** undertaken to the Board on at least an annual basis.
- **Verify compliance with the decisions/action taken by the Board** in respect of internal audit findings/recommendations.
- To **avoid any conflict of interest**, staff assignments should be rotated periodically whenever practicable and internally recruited auditors should not audit activities or functions they performed in the recent past.

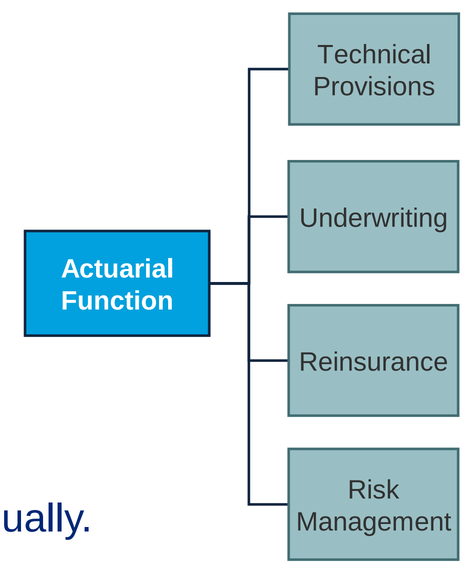
Overview of the System of Governance requirements

Actuarial Function (Art. 48)



The **Actuarial Function** shall:

- **Coordinate the calculation** of technical provisions.
- Ensure the **appropriateness of the methodologies and underlying models** used as well as the **assumptions** made in the calculation of technical provisions.
- Assess the **sufficiency and quality of the data** used in the calculation of technical provisions.
- Compare best estimates **against experience**.
- **Inform the Board** of the reliability and adequacy of the calculation of technical provisions.
- Express an **opinion on the overall underwriting policy**.
- Express an **opinion on the adequacy of reinsurance arrangements**.
- Contribute to the **effective implementation of the risk-management system**, including risk modelling.
- Produce an **actuarial function report** to be submitted to the Board annually.



Overview of the System of Governance requirements

Outsourcing (Art. 49)

Responsibility

- The entity **remains fully responsible** for discharging all of its Solvency II obligations when they outsource functions or activities.

Critical or Important Operational Functions / Activities

Outsourcing of such functions / activities should not:

- **Materially impair the quality** of the system of governance.
- Unduly increase **operational risk**.
- Impair the supervisor's ability to **monitor compliance**.
- Undermine continuous and **satisfactory service** to policyholders.

Notification to Supervisor

- **Prior to outsourcing** critical or important operational functions / activities.
- Any **material** developments.

Outsourcing Policy

An **outsourcing policy** should be documented and implemented.

CBI Domestic Actuarial Regime (CP92)

- Consultation Paper (CP92) published in April 2015.
- Feedback Statement published in October 2015.
- “Domestic Actuarial Regime and Related Governance Requirements under Solvency II” published in March 2016.

Additional requirements introduced by the CBI

- One individual, Head of Actuarial Function (HoAF), will have responsibility for this Key Function.
- Provide an opinion and accompanying report to the Central Bank which address the technical provisions.
- Provide an opinion to the Board on the range of risks and the adequacy of the scenarios, including appropriateness of financial projections, considered as part of the ORSA.

CBI Domestic Actuarial Regime (CP92)

Clarifications from the CBI

Head of Actuarial Function ("HoAF")

- The CBI requirement expects *"that the HoAF be a **member of a recognised actuarial association** and have the appropriate level of **experience**…"*
- The HoAF role may be outsourced for ***low*, *medium low* and *medium high*** undertakings, but for ***high*** impact undertakings this must be an internal role.
- The HoAF will be a **PCF role**

ORSA

- Should **address whether the undertaking is continuously complying** with the requirements regarding the calculation of TPs and potential risks arising from the uncertainties connected to this calculation.
- The CBI **won't prescribe** a form for the ORSA opinion.
- **Not included** within scope of peer review requirements.

CBI Domestic Actuarial Regime (CP92)

Clarifications from the CBI

Actuarial Opinion on Technical Provisions (“AOTP”)

- Actuarial Function is **not excluded from calculating the TPs**. In cases where both calculation and validation of technical provisions is done by the actuarial function the undertaking should have in place processes and procedures in order to avoid conflicts of interest and ensure appropriate independence.
- AOTP should be on a **Solvency II line of business level**.

Risk Margin - Actuarial Report on Technical Provisions

- Report should include a **description of how the SCR**, as calculated by the undertaking, has been **adjusted and projected in order to calculate the Risk Margin**, including a justification of any approximation methods used in the projection.

Peer Review

- The current Peer Review cycle **will not recommence** on implementation of these requirements.
- Undertakings shall not commission the same Reviewing Actuary, or another actuary from the same firm, **for more than three consecutive peer reviews**.
- An **independent recalculation of the TPs is not necessary** but a justification should be provided if a recalculation is not performed

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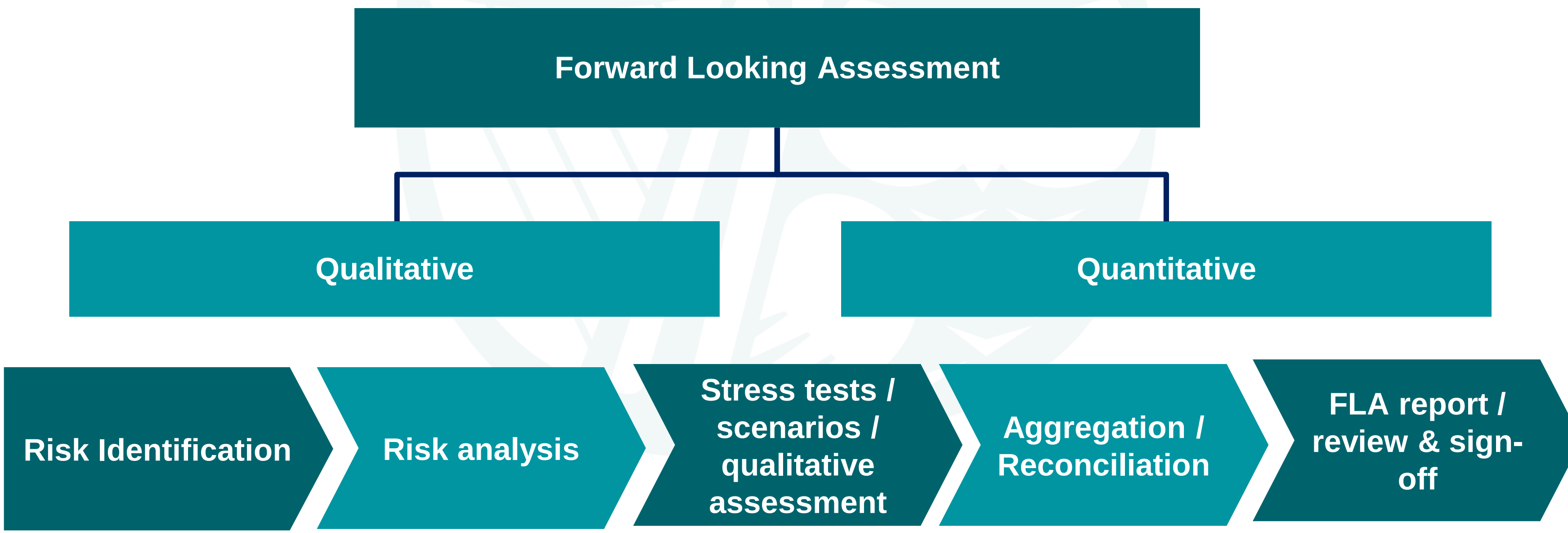
ORSA

What is an ORSA?

EIOPA guidelines:

- Article 45 of the directive: ‘As part of its risk management system every insurance or reinsurance undertaking shall conduct its own risk and solvency assessment.
- CEIOPs had previously defined the ORSA 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*’.

The ORSA is a key part of the risk management process.



The Regulatory Requirements

The main sources of the ORSA requirements are:

- Solvency II Directive (Articles 36, 45 and 246)
- Delegated Acts (Articles 262 and 306)
- EIOPA Guidelines on Own Risk and Solvency Assessment
- Domestic Actuarial Regime and Related Governance Requirements under Solvency II published by the CBI (Sections 2.1.5, 2.3)

Solvency II: Directive Requirements

Article 45: Own Risk and Solvency Assessment

- The own risk and solvency assessment shall include an assessment of at least:
  - The overall solvency needs taking into account the specific risk profile, risk tolerance limits and business strategy
  - Continuous compliance with the Solvency II capital and technical provisions requirements
  - The significance with which the risk profile of the company deviates from the assumptions underlying the SCR (calculated under the Standard Formula or (partial) internal model

- Each firm will have processes in place to identify the risks it faces in the short or long term

- The ORSA is an integral part of the business strategy and be taken into account in making strategic decisions

EIOPA Guidelines on ORSA

1 – General approach (EIOPA Guideline 1)

- Develop for the ORSA its **own processes** with appropriate and adequate techniques, tailored to fit into its organisational structure and risk management system, and taking into consideration the **nature, scale and complexity** of the risks inherent to the business.

2 – Role of Directors (EIOPA Guideline 2)

- The board of directors of the undertaking should take an **active part** in the ORSA, including **steering, how the assessment is to be performed and challenging the results**.

3 – Strategic Tool (EIOPA Guideline 13)

- Use the results of the ORSA and the insights gained during the process for at least:
  - its **capital management**;
  - its **business planning**; and
  - its **product development and design**.

4 – Documentation (EIOPA Guideline 3, 4, 5, 6)

- At least the following documentation is required on the ORSA:
  - the **policy** for the ORSA;
  - a **record** of each ORSA;
  - an **internal report** on each ORSA; and
  - a **supervisory report** of the ORSA.

EIOPA Guidelines on ORSA

5 – Performance of ORSA (EIOPA Guideline 7, 8, 9, 12, 14)

- **Quantify** the capital needs and **describe other means** needed to **address all material risks** irrespective of whether the risks are quantifiable or not. Material risks will be subjected to a sufficiently wide range of **stress tests** or **scenario analyses**.
- The overall solvency needs should be forward-looking, including a **medium-term or long-term perspective** as appropriate.
- Explain how the use of recognition and valuation bases other than the Solvency II bases ensures **better consideration of its specific risk profile, approved risk tolerance limits and business strategy**.
- **Quantitatively** estimate impact using different recognition and valuation basis on the overall solvency needs.
- Assess whether its **risk profile deviates from the assumptions underlying the Solvency II SCR** calculated with the Standard Formula and whether these deviations are significant.
- The undertaking should perform the ORSA **at least annually**.

6 – Continuous Compliance (EIOPA Guideline 10, 11)

- Compliance with requirements regarding calculation of **technical provisions** and **regulatory capital requirements**.

EIOPA Guidelines on ORSA

7 – Group ORSA: Scope and Group specificities on overall solvency needs (EIOPA Guideline 15, 17, 20)

- Group ORSA should reflect the **nature** of the group structure and its **risk profile**. It should cover the **material risks** arising from **all** group entities.
- Assess impact of **all group specific risks** and **interdependencies** within the group and on the overall solvency needs and the fact that some risks may be scaled up at group level.
- The group ORSA record should include at least a description on how the following factors were taken into consideration for the assessment of overall solvency needs:
  - Identification of possible **sources of capital** within the group and identification of potential needs for **additional capital**;
  - Assessment of **availability, transferability or fungibility** of capital;
  - References to any envisaged **transfer of capital** within the group, which would have a **material impact** on any entity of the group and its **consequences**;
  - Alignment of **individual strategies** with the ones established at the level of the group;
  - **Specific risks** the group could be exposed to.
- Include **risks** of the business in **third countries** in a consistent manner as it does for EEA business with special attention to the **assessment of transferability** and **fungibility** of capital.

EIOPA Guidelines on ORSA

8 – Group ORSA: Reporting to supervisory authorities (EIOPA Guideline 16, 19)

- **Group supervisory ORSA** report should be sent to the **group supervisor**. If a **single** ORSA document has been performed, should ensure that, if requested by a member or a new member of the college, a **translation into the official language** of that Member State of the part of the ORSA information concerning the related undertaking is provided, in a timely manner.
- In case of **application** to undertake a **single** group ORSA the group supervisor should be provided with:
  – A **list of the undertakings** for which the individual assessments required by Article 45 of Solvency II are covered in the single ORSA document including the reason of the choice made;
  – A description of how the **governance requirements** are met at the undertaking level, in particular how the subsidiaries **Boards** are involved in the **assessment process** and **approval** of the outcome;
  – Description of how the single ORSA **document is organised** in order to allow the group supervisor to separate individual assessments for the other supervisors in the college;
  – Where necessary, a specific indication on required **translations**, with specific attention to timing and content.

EIOPA Guidelines on ORSA

9 – Group ORSA: Continuous compliance with regulatory capital requirements (EIOPA Guideline 18)

- The group ORSA record should include **at least** a description on how the following factors were taken into consideration for the assessment of continuous compliance with regulatory requirements:
  - Identification of possible **sources of own funds** within the group and if there is a need for **additional own funds**;
  - Assessment of **availability, transferability or fungibility** of own funds;
  - References to any **planned transfer** of own funds within the group, which would have a **material impact** on any entity of the group and its consequences;
  - Alignment of **individual strategies** with the ones established at the level of the group;
  - **Specific risks** the group could be exposed to.
- The **CBI** expects the assessment of the continuous compliance for **groups above the threshold**.

CBI Feedback

Board Ownership

- In some cases, Board acting as a '**reviewer**' of the ORSA.
- The ORSA process must be:
  - actively considered by the Board;
  - top-down;
  - embedded within the undertaking.

Assessment of Key Risks

- Consideration must be given to **all material** risks
  - Risks not captured by SCR;
  - quantifiable and non-quantifiable;
- Appropriate **mitigants** must be described including for non-quantifiable risks.

Assessment of Overall Solvency Needs

- Overall solvency needs assessment constitutes undertaking's **own view** of material risks which it faces;
- Assessment should allow for any **limitations** of the **SCR** in respect of the undertaking;
- Undertakings should use the overall solvency needs assessment process to establish and justify an **appropriate capital level** for the undertaking and link this to strategy and decision making.

CBI Feedback

Standard Formula Reliance and Continuous compliance

- Level of **reliance on SF/IM** was very **high**;
- Assessment of how **risk profile deviates** from the **assumptions** underlying the **SCR** calculation should be fully **discussed** in the **ORSA report**.
- Assessment of **compliance** on continuous basis with Solvency **II regulatory capital** and **technical provision requirements** should also be discussed in the ORSA report.

CBI Feedback – Time Horizon

- Too **short term**;
- Should include a “medium-term or long-term perspective as appropriate”.

Pillar 2 – System of Governance Summary

- A robust **system of governance** is a pre-requisite for an efficient solvency system. Undertakings must comply with the requirements on **fit and proper**, **risk management**, **the ORSA** and key function requirements.

- The key functions are **internal control**, **internal audit**, **risk management** and the **actuarial function**. **Outsourcing** and its impact on the entity must be considered.

- The **Board** is **responsible** for all elements of the overall system of governance but also for setting **"tone at the top"** and embedding an appropriate **risk culture**.

- Irish regulation has been ahead of Solvency II with respect to the **Corporate Governance Code** and **Fitness & Probity** regulations.

- An effective risk management system should **link to strategy**, **link capital** to risk and **ensure all material risks** are identified, measured, monitored and reported.

- Typical components of a risk management system are the **risk appetite** (links **upwards to risk capacity, philosophy & strategy**) and links **downwards** to **risk tolerance** and **risk limits**, all of which are supported by the **risk framework, policies, processes and reporting**.

Pillar 2 – ORSA Summary

- ORSA is the entirety of the processes and procedures employed to identify, assess, monitor, mange and report the short and long-term risks a company faces (or may face) and to determine the own funds necessary to ensure that the company's overall solvency needs are met at all times.
- Board must take an **active part** in the ORSA, steer its performance and challenge the results.
- ORSA is as much about the process as the report; documentation should include:

ORSA Policy	Record of each ORSA	Internal ORSA Report	External (supervisory) ORSA Report

- Assessment of "own solvency needs" must include both **quantitative** and **qualitative** aspects:
  - An assessment of the required 'economic capital'.
  - Material risks must be subject to sufficient stress testing / scenario analysis.
  - Assessment is over the medium / long term – 'at least the business planning period'.

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Questions