



**The Actuarial Profession**

making financial sense of the future

Life Actuarial Convention  
Paul Brenchley and Matthew Murphy

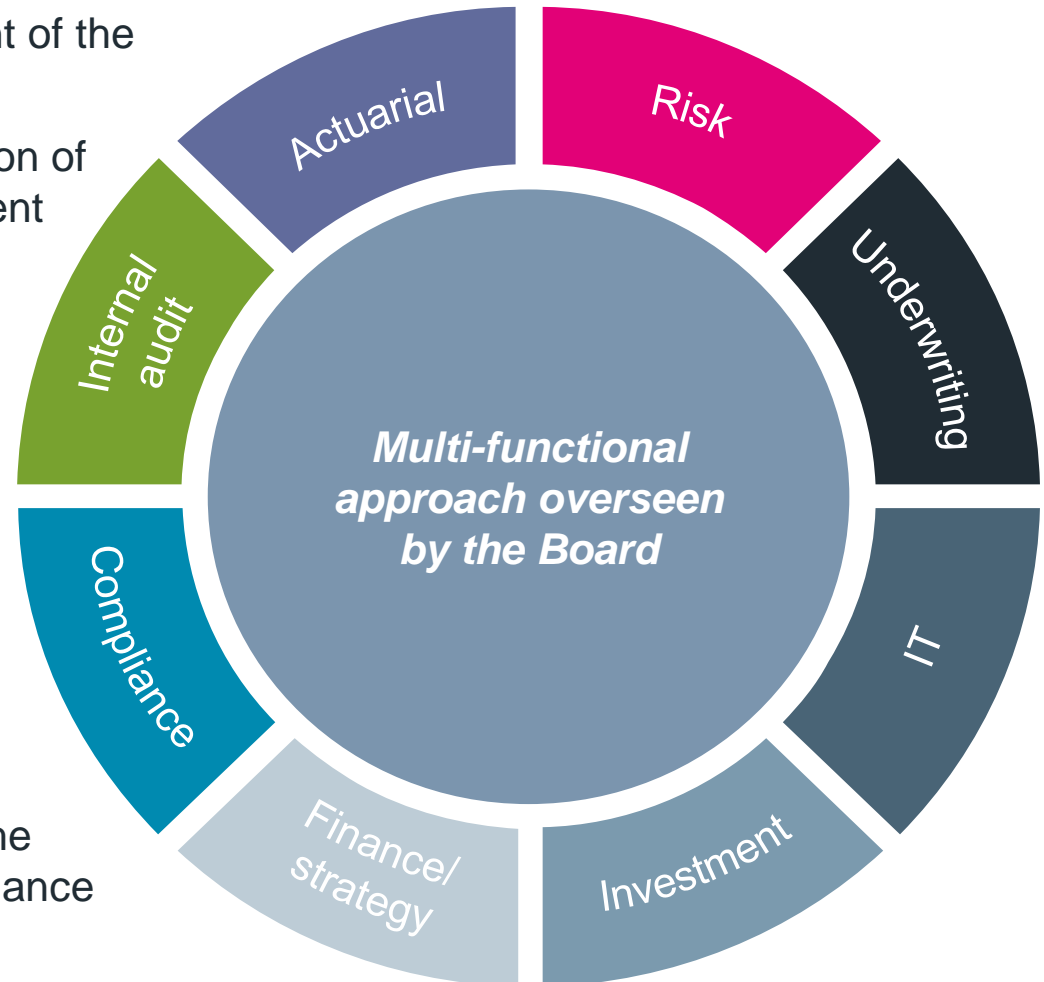
# Solvency II

## ORSA and the Standard Formula

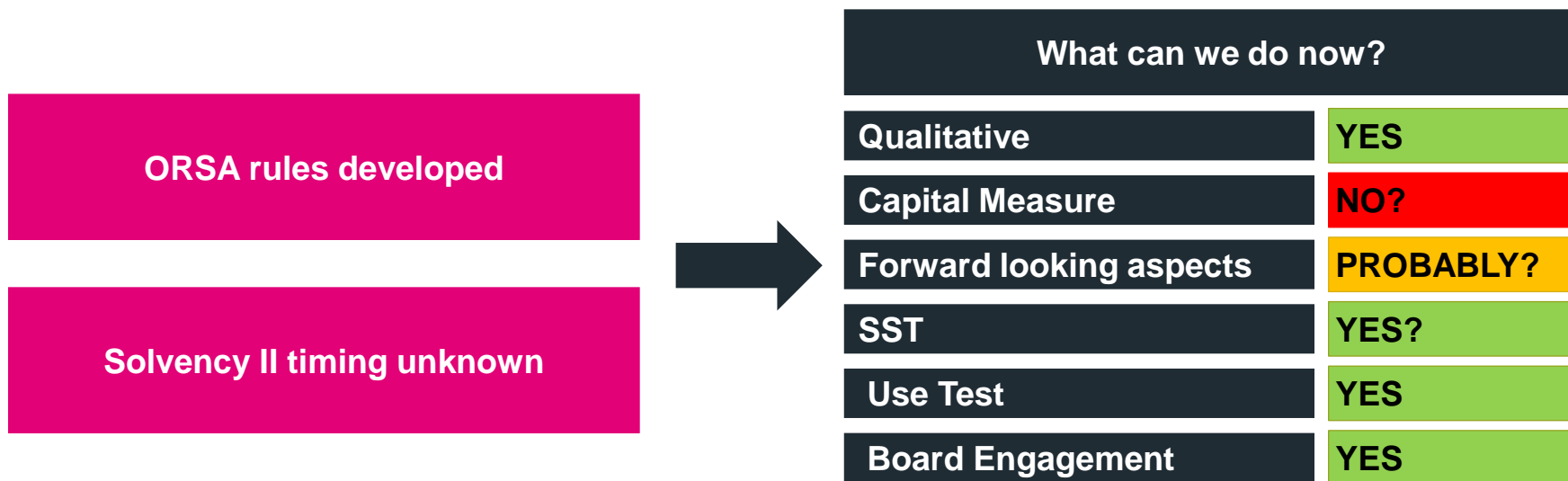
6 November 2012

# Introduction

- The ORSA is a central component of the Solvency II regime and 'ICA plus'
- The ORSA builds on the foundation of sound risk and capital management and draws strategy/business planning closer to these areas
- ORSA should be used as a tool to monitor and run the business
- Involvement from many stakeholders is important in shaping the ORSA and raising awareness
- The Board need to play an active role in steering and challenging the ORSA process and results to enhance commerciality.



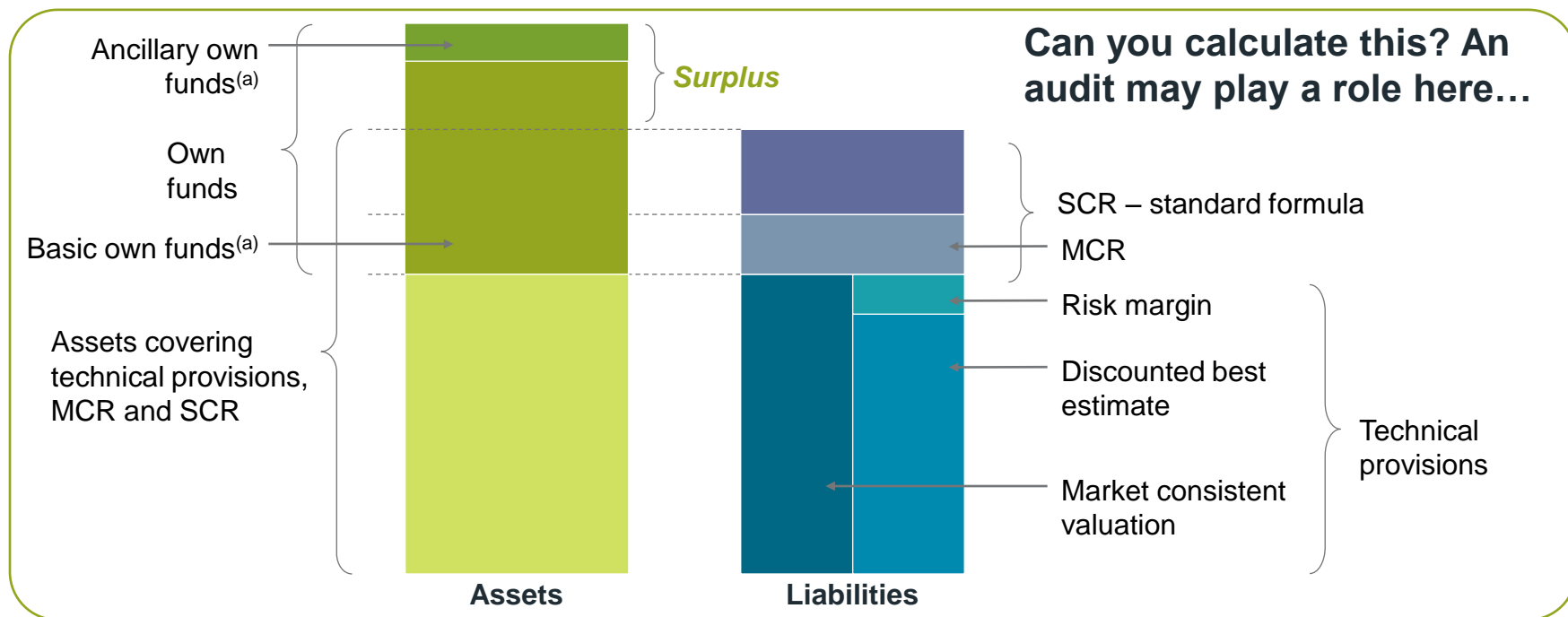
# KPMG market observation – current status



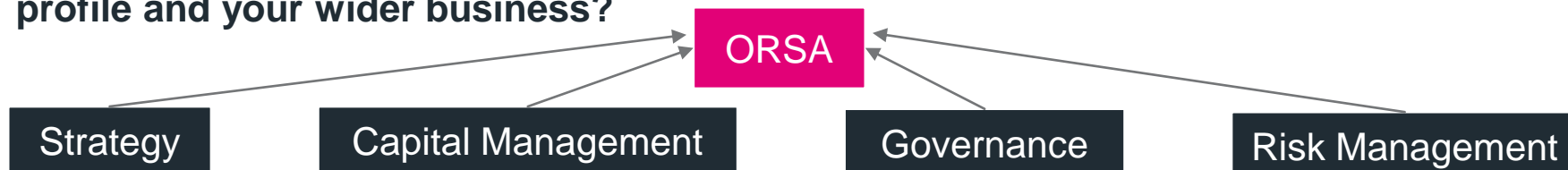
## ORSA – July level 3 paper – main changes

- ORSA policy – particularly on how the forward-looking assessment is addressed and stress and scenario testing
- Greater emphasis on the consideration of own funds
- New requirements for inclusion in Group ORSA report
- Explicit references to not duplicating or re-performing tasks in the ORSA
- Anticipated that ORSA will be part of the 'ICAS plus' regime.

# How will a standard formula firm be regulated under Solvency II?

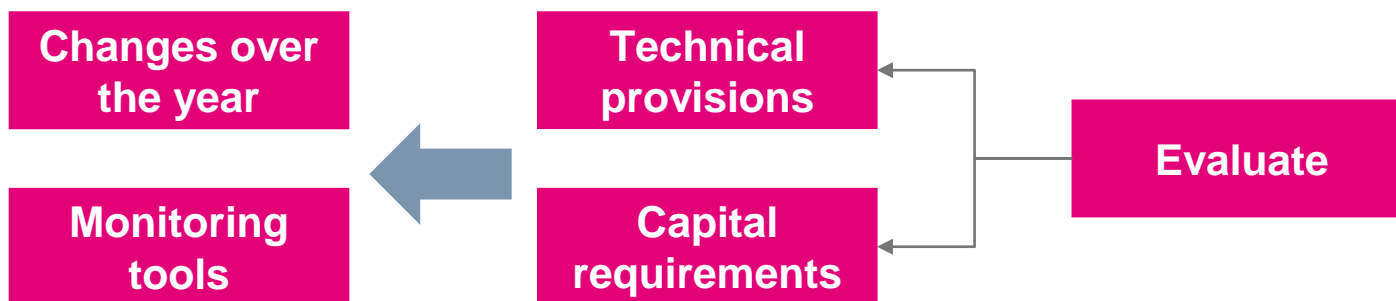


Where is there an expectation that you will think about the above against your risk profile and your wider business?

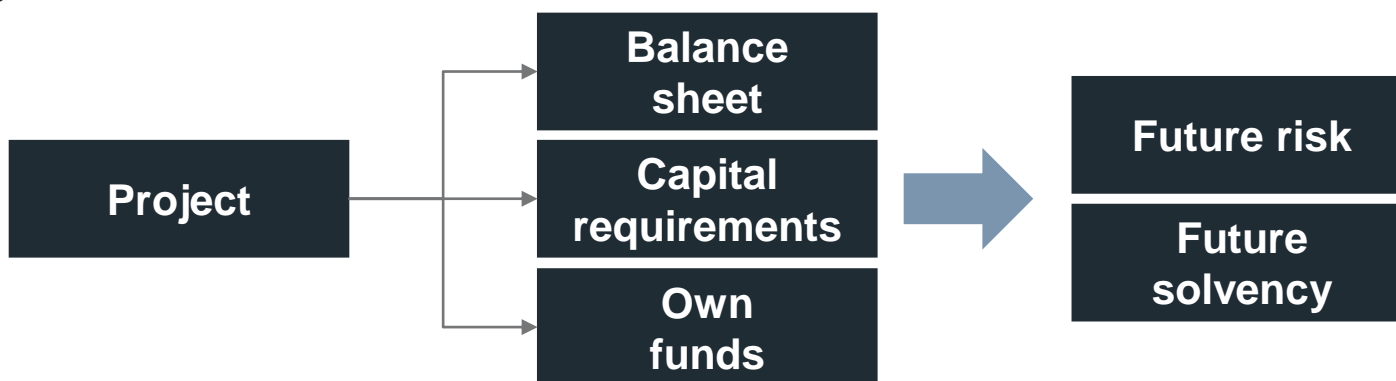


# ORSA perspectives

## Looking into the past and current monitoring ...



## Looking into the future ...



# Key components of the ORSA

## ORSA policy

The ORSA policy defines what the business should do to perform the ORSA process. This will be used by the business to provide guidelines to perform the process.

## ORSA process


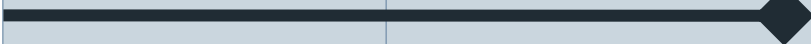



The ORSA process assesses capital requirements and demonstrates how these are linked to the risk assessment and decision making processes.

## ORSA report

The ORSA report 'tells the story' of the undertaking's current risk and capital management practices. It demonstrates to the regulators that the undertaking has the necessary available level of capital to sustain significant negative impacts now and in the future.

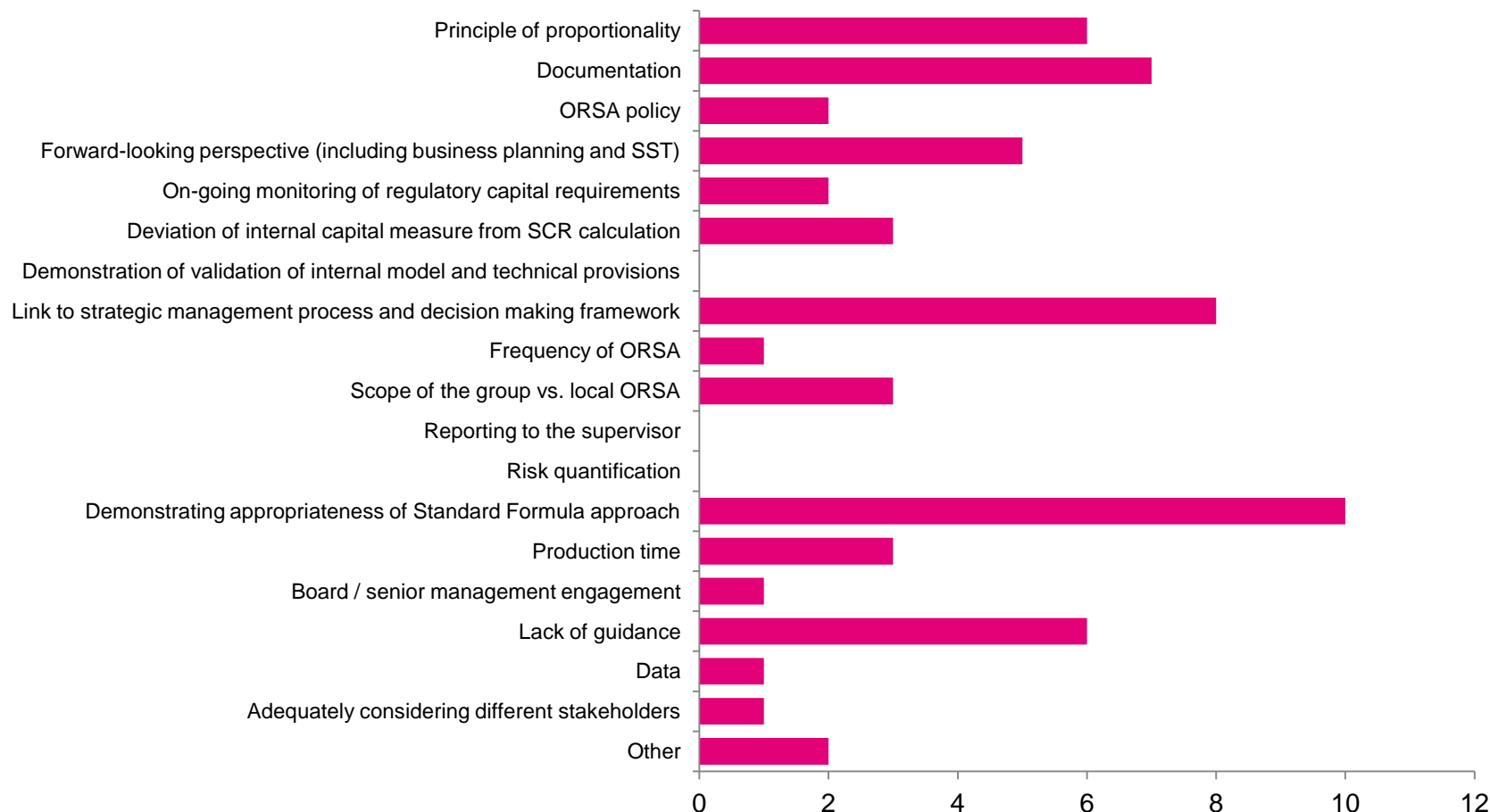
# Current market progress

- Progress on ORSA across the market has varied however based on the clients we have worked with/interacted with we have seen the following:

Component	Design	Implementation	Operational
Business awareness			
ORSA report			
ORSA policy			
ORSA process design			
Ongoing monitoring			

- Most firms are aiming to have a full ORSA process up and running by Q2/Q3 2013
- Implementation challenges exist due to the strong dependency on other areas of Solvency II activity to deliver and the impact on BaU operations.

# Challenges standard formula firms are having with the ORSA

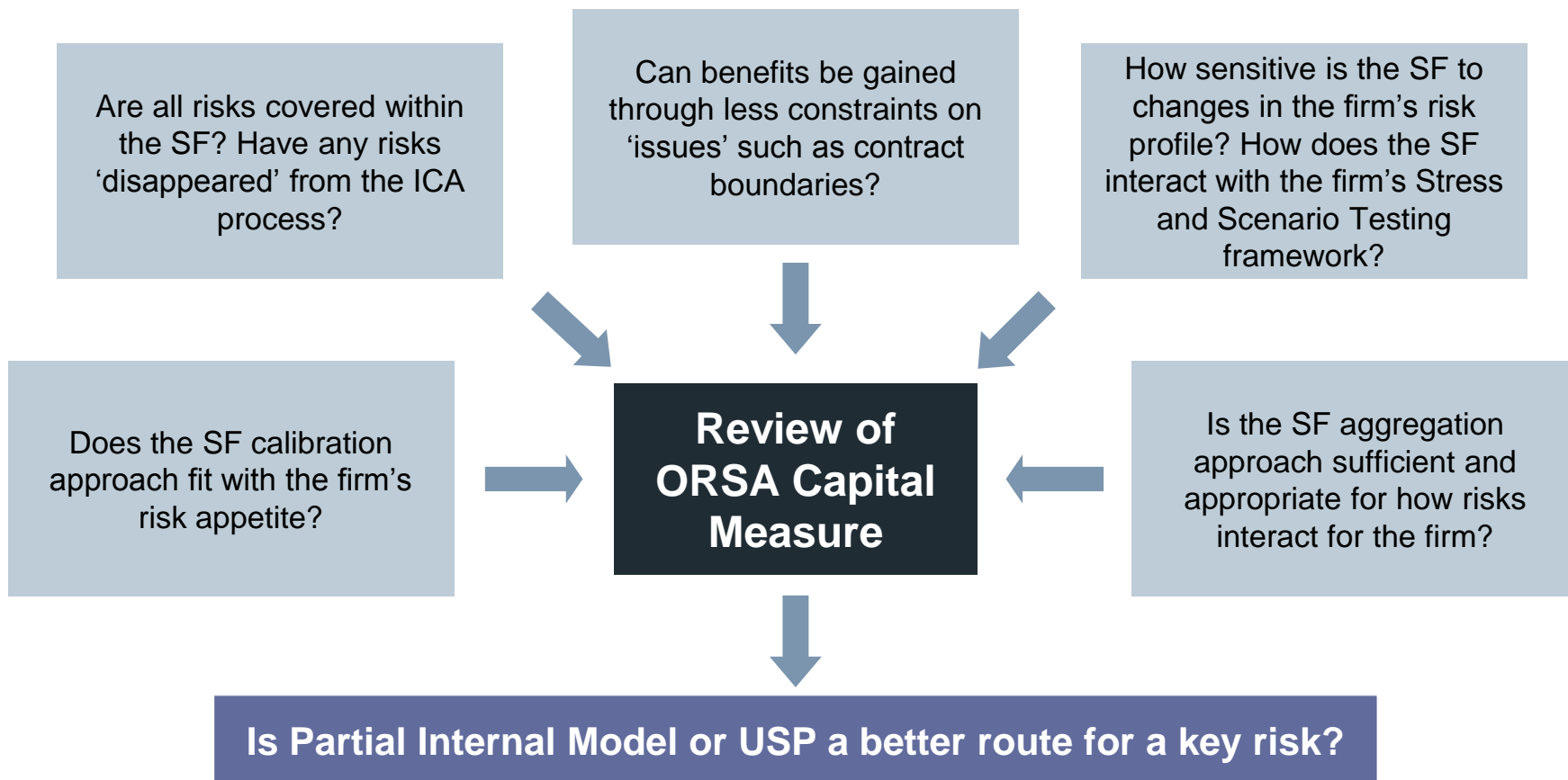


Source: KPMG Technical Practices Survey 2012 (total number of Standard Formula respondents = 16)



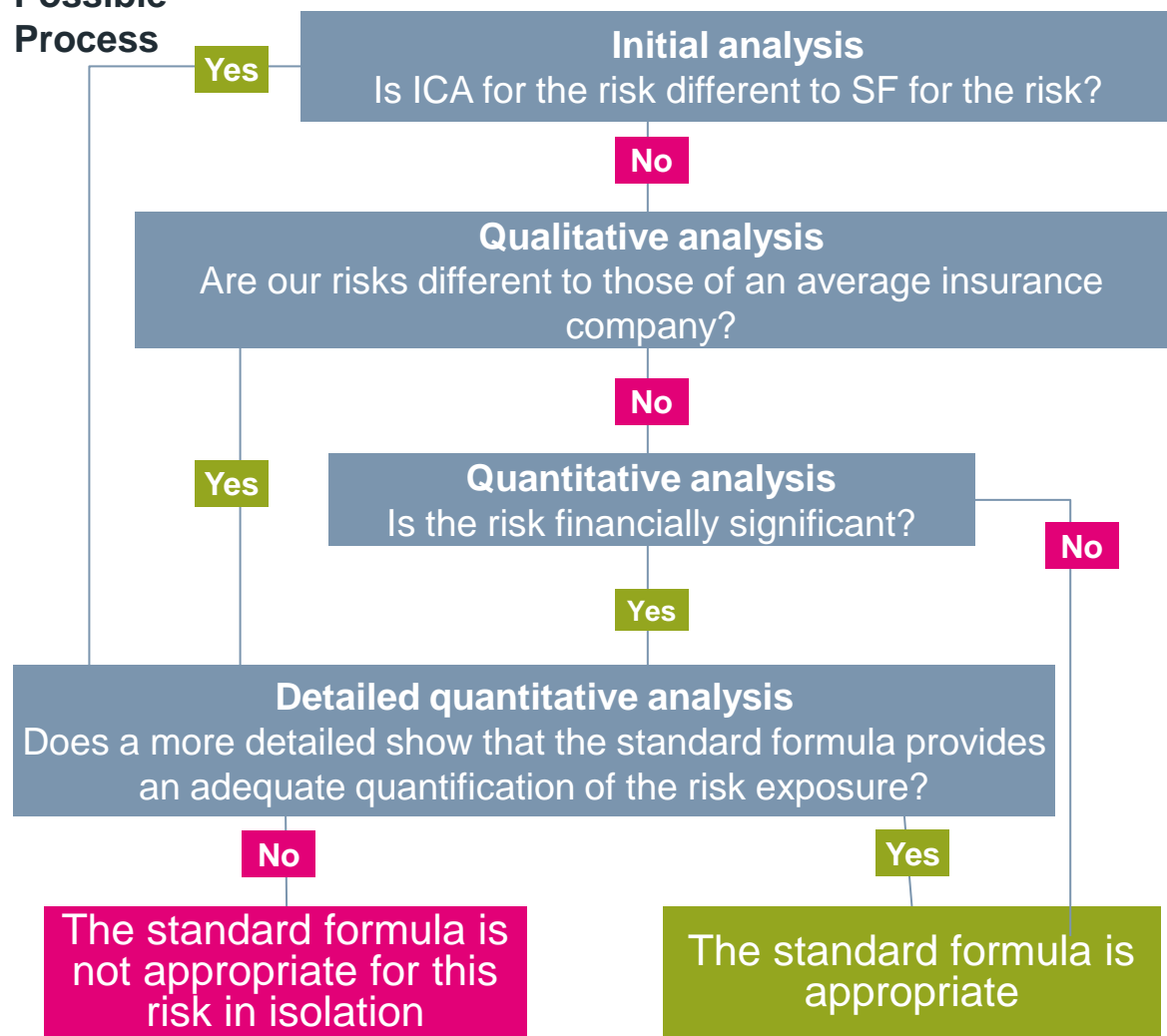
# The quantitative work required in the ORSA

**Firms using the Standard Formula for Pillar 1 will need to assess whether this is a suitable measure for use within the ORSA**



# Suitability of the SCR: Outline approach

## Possible Process



Comparison between ICA and Solvency II SC will give a good feel for the other tests

Typical qualitative questions include:

- What products do we have?
- What investment strategy do we follow?
- What is our customer base?

Materiality overlay

*“Choosing to use the standard formula is an active choice”*

**Slavko Gvero (FSA Solvency II Implementation Manager)**

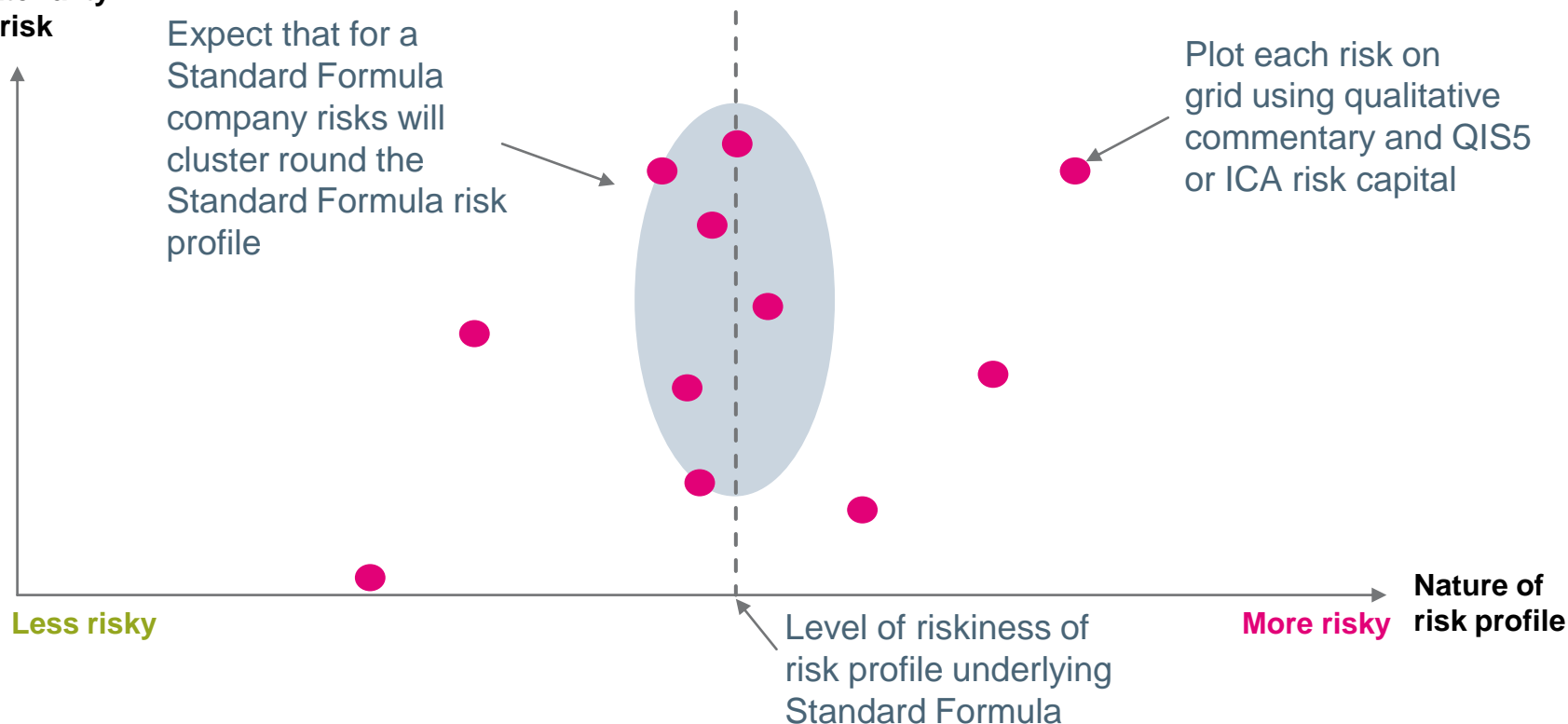
*Stated at speech to firms attending implementation seminars held by the Association of British Insurers, 25 May 2012*

# ORSA: Guideline 12 Deviations from assumptions underlying the SCR calculation

The undertaking may initially assess deviations between its risk profile and the assumptions underlying the SCR calculation on a qualitative basis. If this assessment indicates that the undertaking's risk profile deviates materially from the assumptions underlying the SCR calculation the undertaking should quantify the significance of the deviation.

**(EIOPA Final Report on Public Consultation No. 11/008 On the proposal for Guidelines On ORSA)**

**Materiality of risk**

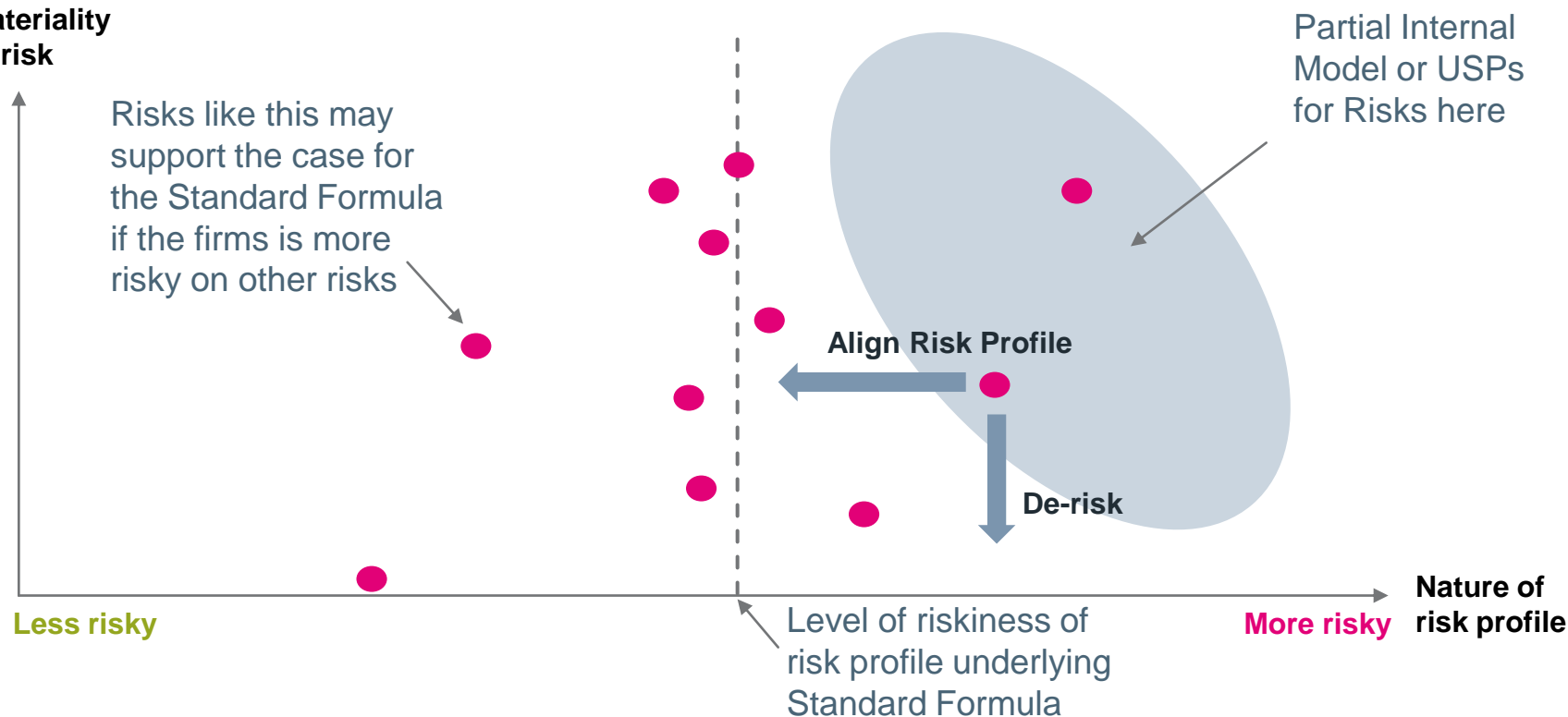


# ORSA: Guideline 12 Deviations from assumptions underlying the SCR calculation

If the outcome of this qualitative and quantitative assessment is that there are significant deviations between the risk profile of the undertaking and the SCR calculation, the undertaking needs to consider how this could be addressed. It could decide to align its risk profile with the standard formula, to use undertaking-specific parameters, where this is allowed, or to develop a (partial) internal model. Alternatively, the undertaking could decide to de-risk.

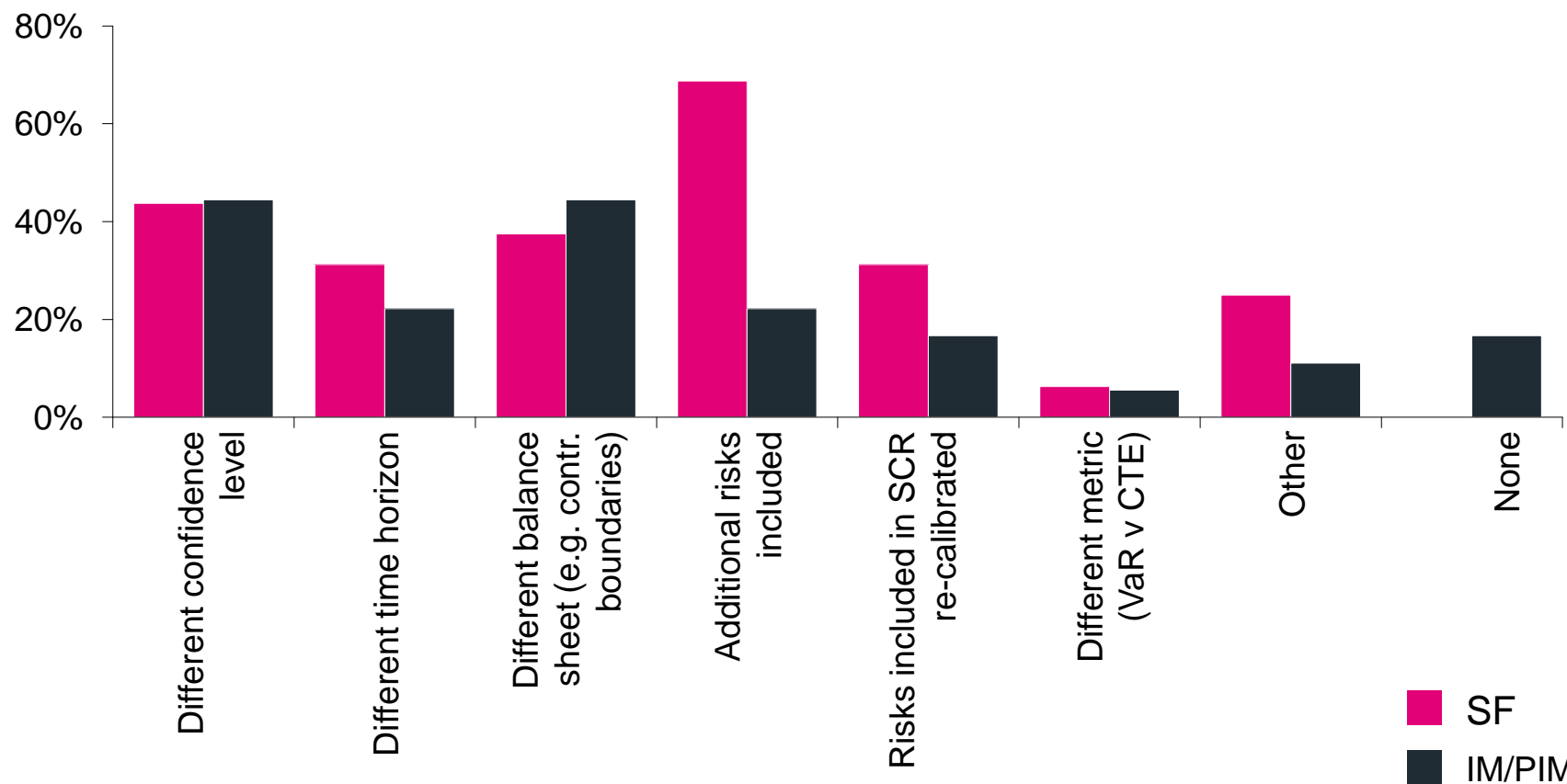
**(EIOPA Final Report on Public Consultation No. 11/008 On the proposal for Guidelines On ORSA)**

**Materiality of risk**



# Pillar 1 and Pillar 2 capital measure will be different

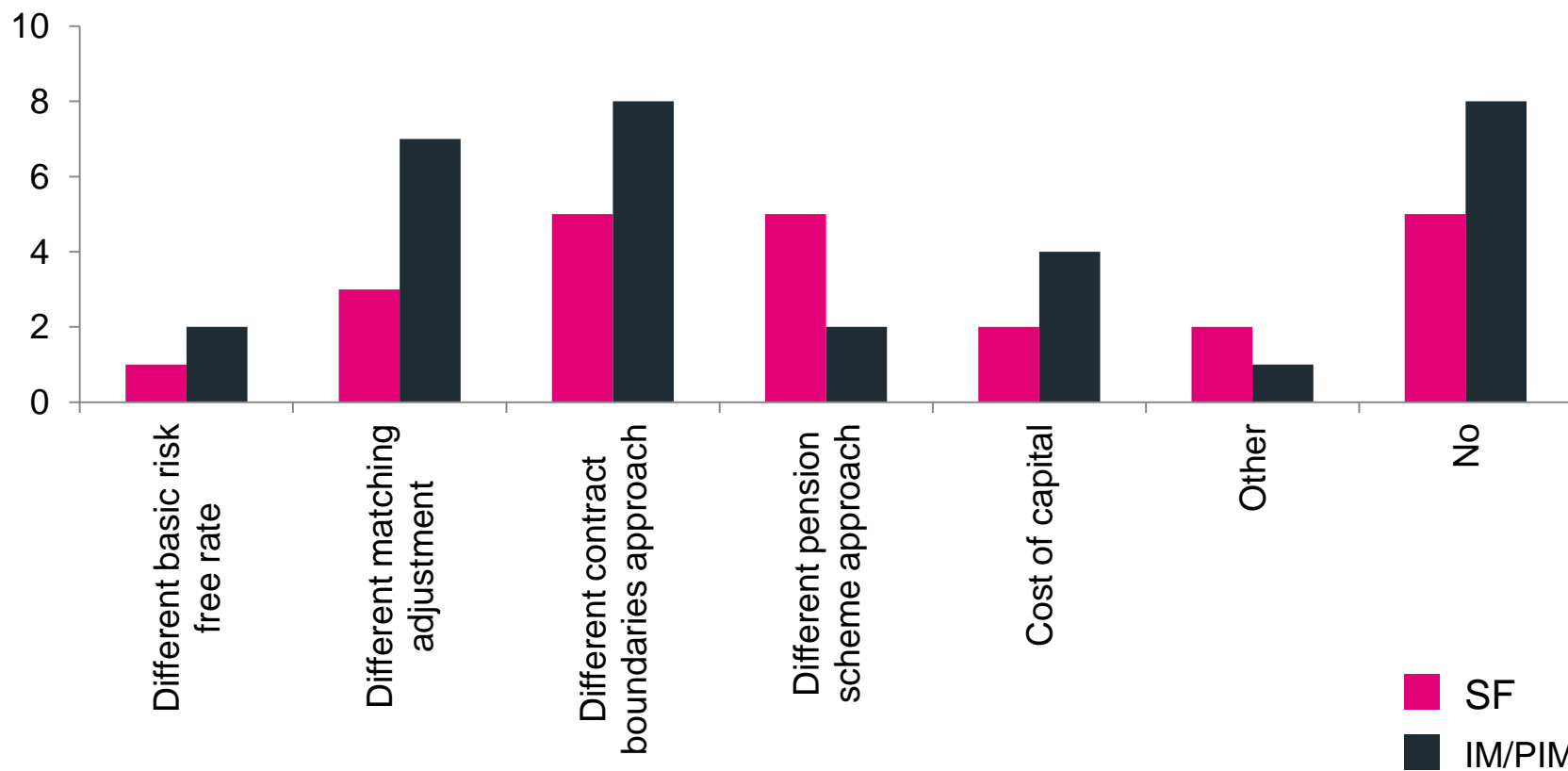
What differences are there between your ORSA capital measure and your Pillar 1 SCR?



Source: KPMG Technical Practices Survey 2012 (total number of respondents = 35)

# Pillar 1 and Pillar 2 balance sheet will be different

Will you have a different approach for calculation of the balance sheet under ORSA compared to Pillar 1?



Source: KPMG Technical Practices Survey 2012 (total number of respondents = 35)

# Pillar 2 – ORSA – Projection options and considerations

Choice of projection methodology will need to consider the specific features of the business but is likely to be heavily dependent on the following practical considerations:

## Accuracy

- Materiality limits will drive choice of the projection method and effort required

## Granularity

- Needs to meet business requirements

## Usability

- Ease to re-run projection method at ad hoc period
- Ease to re-calibrate and update projection methodology

## Cost Benefit

- Level of effort and expertise required to implement and update

## Communication

- Senior management understanding of projection methods.

## Standard Formula firms tend to use straightforward approaches

Determine set of projection methodologies of varying sophistication:

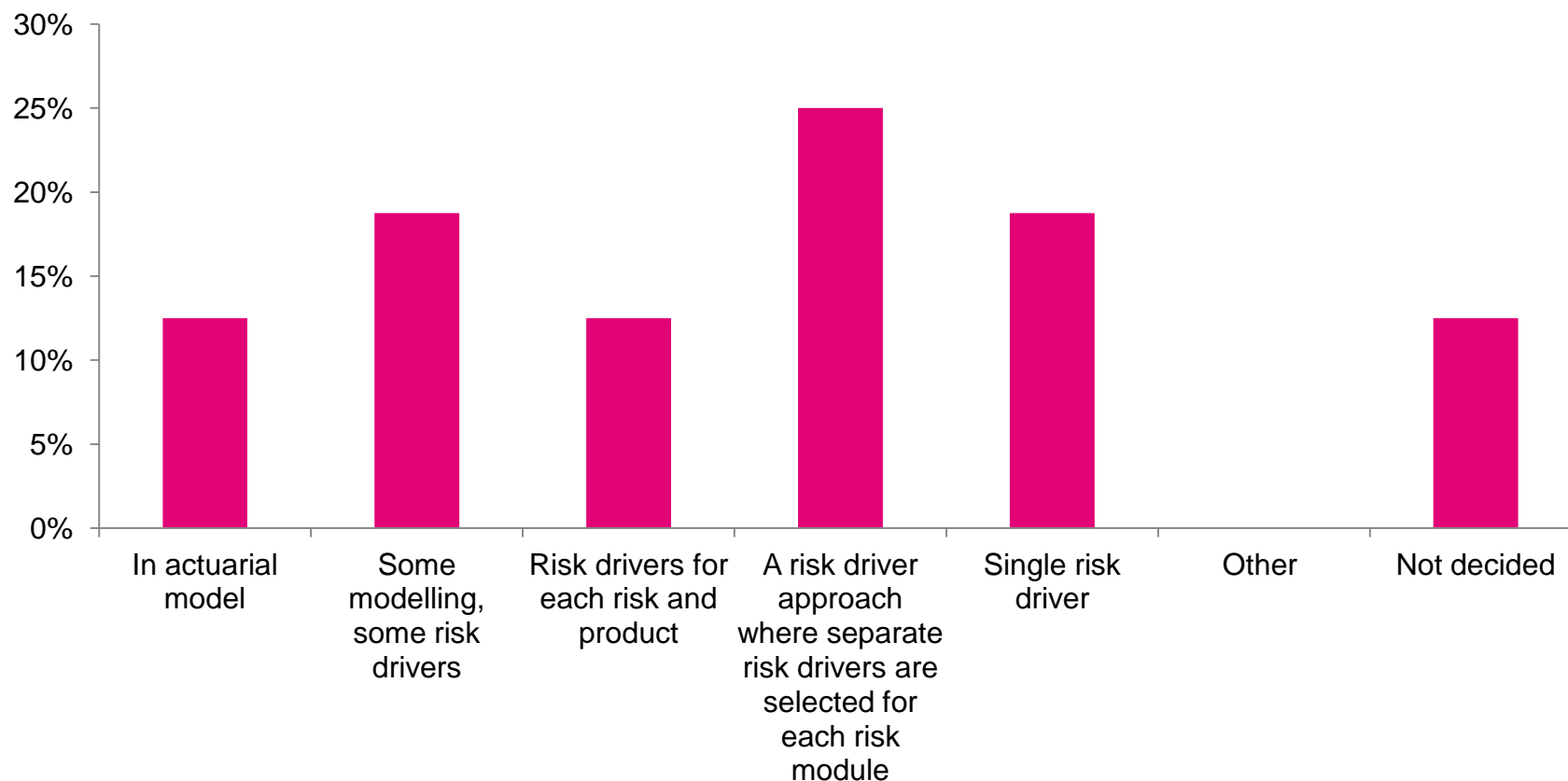
- Model projections
- Factor based run-off
- Constant SCR

These are then used for different products/risks.

Some firms build on the Risk Margin methodology. Technical Practices Survey showed 75% of Standard Formula companies using the same methodology for ORSA projections and the Risk Margin. However the different coverage of risks and time horizon mean this cannot always be assumed to be appropriate.

# Projections – needed for a standard formula firm

Which of the following best describes your method of projecting the capital measure for the ORSA report?





# Three key components of Stress and Scenario Testing (SST)

Component	What is the component	Why do we need the components?
<b>Sensitivity testing/stress tests</b>	<ul style="list-style-type: none"> <li>• A single parameter (or combination of parameters) stress, constant over time</li> <li>• Represent a range of adverse developments over one-year or instantaneously</li> </ul>	<ul style="list-style-type: none"> <li>• Allows for standard comparison of risk exposure and changes over time of risks across the business and informs on the impact of changes in economic and business conditions</li> <li>• Provides a basis for assessing management actions to mitigate individual risks</li> </ul>
<b>Scenario testing/analysis</b>	<ul style="list-style-type: none"> <li>• A forward looking assessment of adverse changes in a combination of macro economic and non-economic key indicators</li> <li>• The analysis should be informed by historic analysis and expert judgement</li> </ul>	<ul style="list-style-type: none"> <li>• To understand quantitatively and qualitatively the firm's exposure to macro (systematic) scenarios which represent a combination of events</li> <li>• To estimate the associated impacts of such scenarios which could adversely affect the business, accompanied by an assessment of the likelihood of occurrence</li> </ul>
<b>Reverse stress testing</b>	<ul style="list-style-type: none"> <li>• An iterative process to identify the type and severity of an event or combination of events which could cause the business model of the firm to fail</li> </ul>	<ul style="list-style-type: none"> <li>• To develop a complete understanding of the circumstances under which the business model fail</li> <li>• To estimate of the likelihood of occurrence of such a scenario</li> </ul>

# SST – Draft ORSA requirements

## Identify risks to a sufficiently wide range of stress test/scenarios

- Reflect the risks arising from all assets and liabilities, including intra-group and off-balance sheet arrangements
- Reflect the undertaking's management practices, systems and controls
- Connect business planning to solvency needs
- Include explicit identification of possible future scenarios and address potential external stress
- Use a valuation basis that is consistent throughout the overall solvency needs assessment.

## Management Actions

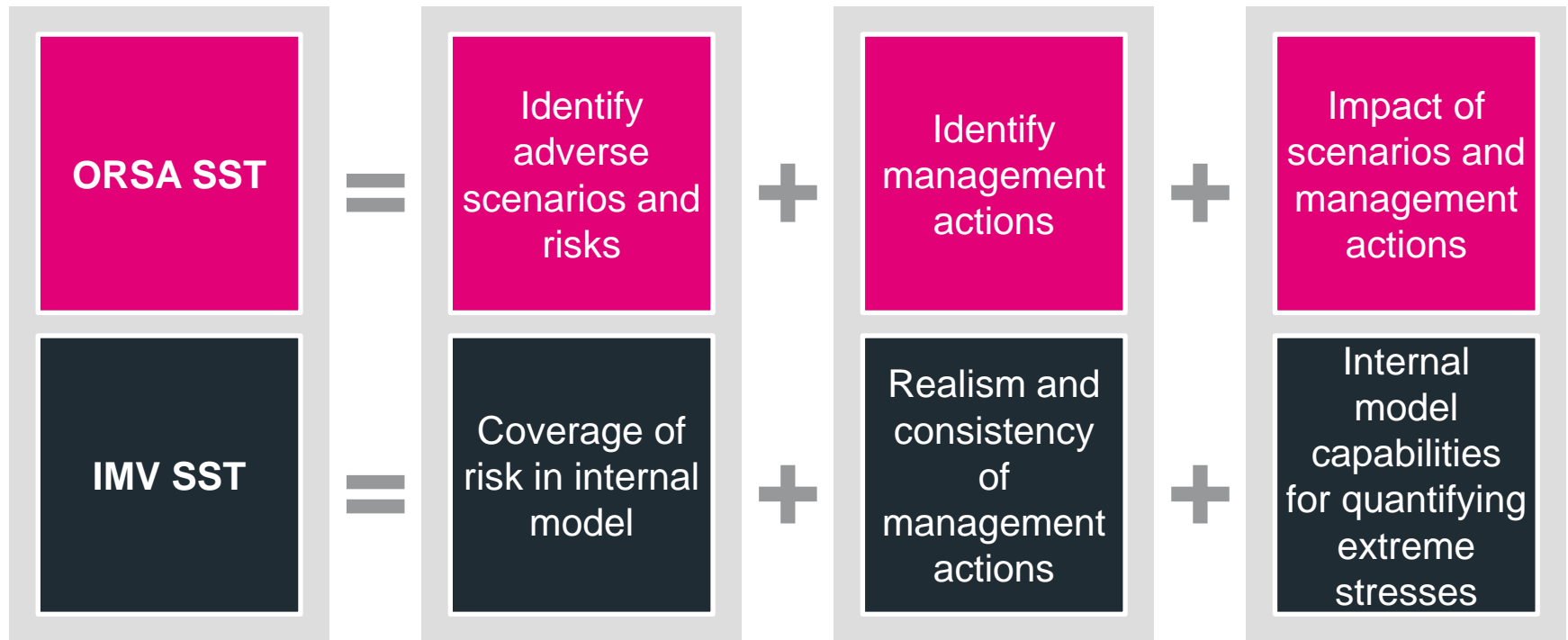
- When assessing the overall solvency needs, an undertaking also has to take into account management actions that may be adopted in adverse circumstances. When relying on such prospective management actions, an undertaking assesses the implications of taking these actions, including their financial effect, and takes into consideration any preconditions that might affect the efficacy of management actions as risk mitigators.

## ORSA Policy

- How stress tests/sensitivity analyses are to be performed and how often are to be performed.

Source: Level 3 ORSA draft guidance

# SST – ORSA versus Internal Model Validation requirements

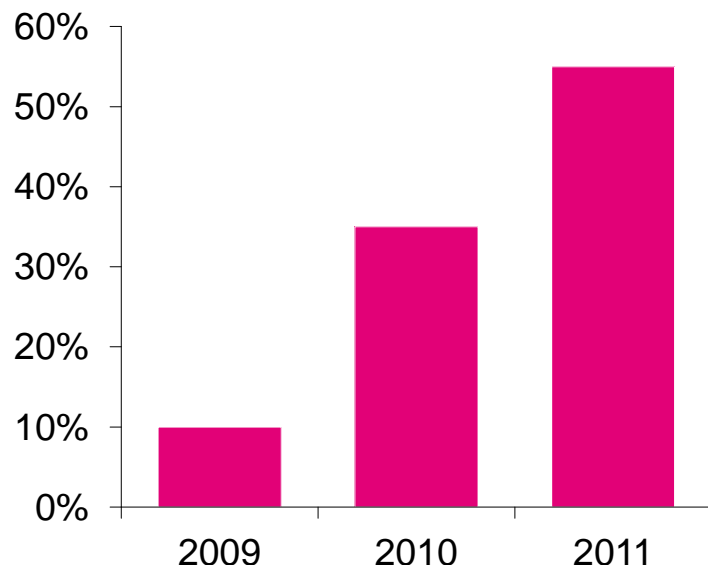


**“ Some firms have made use of limited stress and scenario testing...  
Some firms have confused stress and scenario testing with sensitivity testing ”**  
– FSA IMAP Letter, May 2012

# The need to bring the Board along with you

## Training start dates

- 90% of respondents confirmed that Board training had started as at April 2012. The majority of firms begun training in 2011



## Number of sessions

- Board** – The average number of training sessions held was 5, ranging from 1 to 12
- Risk Committee** – 76% of respondents confirmed that that training has been extended to the Risk Committees. The average number of sessions being 3, the highest was 8 and the lowest was 1

## Separate one-to-one training

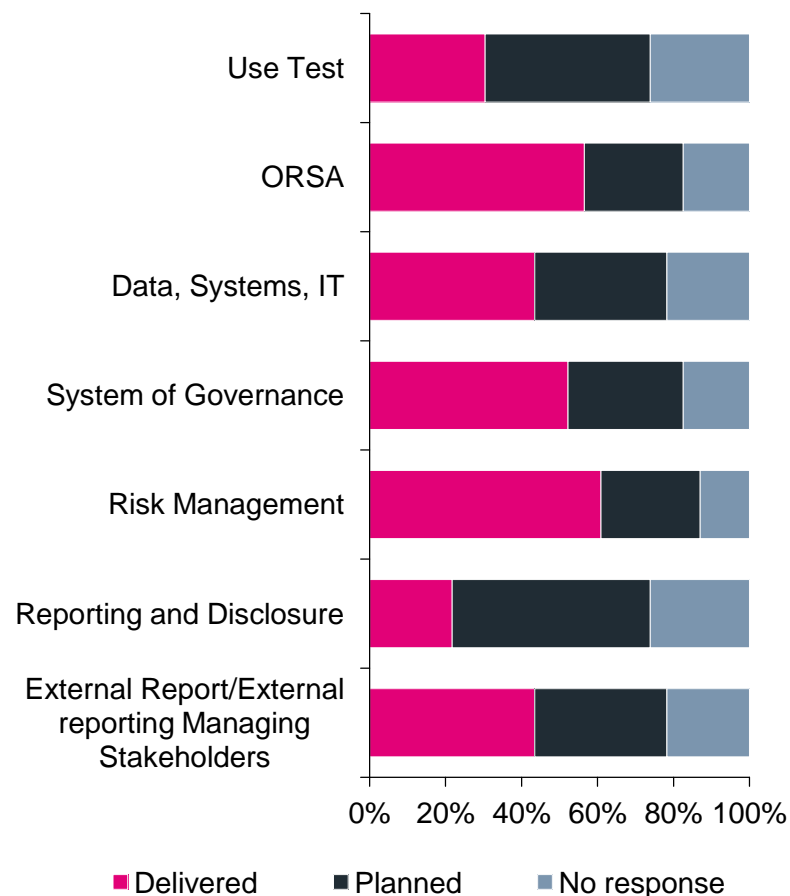
- Some firms have broken training down into one-to-one sessions with the NEDs and Executives – tailoring training to meet the needs of individuals.

**Most respondents said that they had not done enough with their Boards**

# Boards have not had enough training to date...

## Solvency II training hours

- 80% received less than 15 hours of training during 2011
- 65% of firms will spend less than 12 hours on formal Board Solvency II training in 2012
- Focus to date has been Pillar 1 – perhaps not surprising given market pressures and the continuing Eurozone economic crisis
- Those firms that have also covered Pillar 2 in particular, are going to be better placed to realise both regulatory and commercial benefits.



Source: KPMG Publication “Bringing Solvency II alive in the boardroom – are you doing enough?” July 2012

# Making ORSA real – ‘Dry run’ approaches

## From our Technical Practices Survey:

- 50% of firms have already started a ‘dry run’ (this is not just standard formula)
  - Most of rest aim to start a ‘dry run’ in 2012
- 50% of firms stated they will be able to do full run by end of 2012
  - Remainder plan this for 2013.

### Market approaches

- We have seen a range of approaches from firms
  - Desk Based ORSA
  - Workshop Based
  - Condensed Process
  - Leverage ICA/Available inputs
- Focus on pulling documentation together.

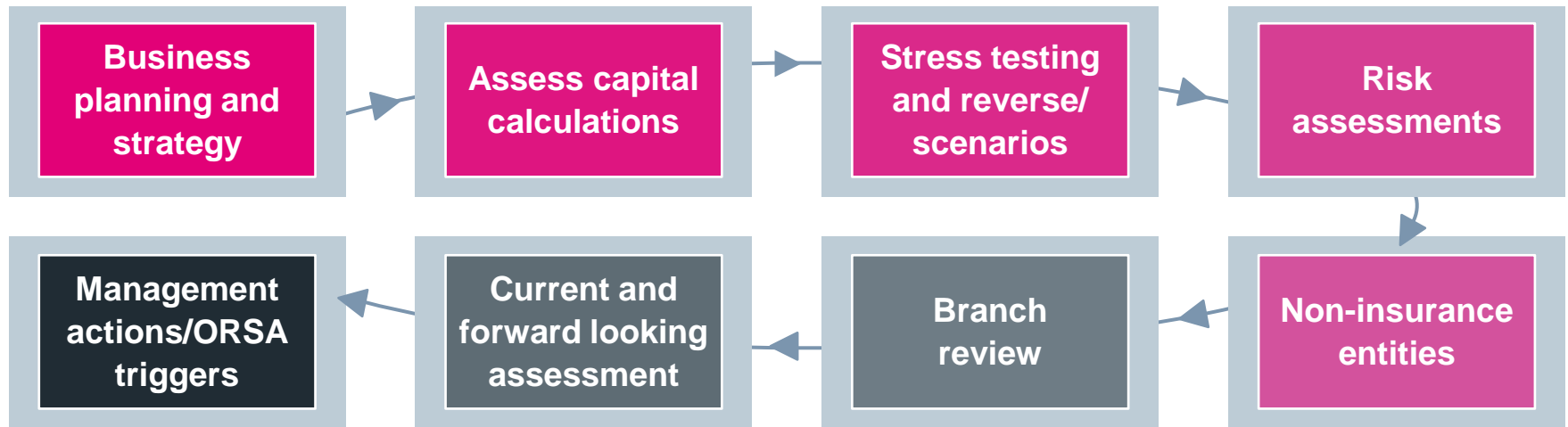
### Challenges

- Engagement of the business and other functions in the process
- Testing a full process in BAU environment
- Over focus on the ORSA report as the main outcome
- Large dependency on existing business processes and those being developed for Solvency II
- Running the annual process while ‘building blocks’ in development (e.g. risk appetite).

# 'Dry run' exercise – an example

## Preparation

- Engagement of key stakeholders
- Development of inputs needed to deliver process.



1. Gap analysis of process steps and inputs needed
2. Board report of findings
3. ORSA report contents.

# Any questions?

For further information please see our website –

<http://www.kpmg.com/UK/en/WhatWeDo/MarketSectors/FinancialServices/Insurance/Pages/SolvencyII=Solved.asp>

The screenshot shows the KPMG UK website. The header includes the KPMG logo, navigation links (Contact, Site map, Help), and a search bar. The main navigation bar lists 'Home', 'Who we are', 'What we do', 'Issues & Insights', 'Join us', 'Media', and 'Alumni'. The left sidebar contains a list of services and market sectors, with 'Solvency II = solved' highlighted under 'Financial Services'. The main content area features a large image of a hand writing '(Solvency II) = SOLVED' on a whiteboard, with the equation  $27 = x^2 - 4x + 2x -$  visible. Below the image, the text reads: 'Solvency II represents an opportunity to not only improve insurers' operations, but also develop significant competitive advantage in a challenging market. By cutting through the complexities of regulatory change, we can help them embrace Solvency II and derive benefits across the breadth and depth of their business.' This is followed by a quote from Phil Smart, Head of Solvency II, KPMG. The right sidebar contains a section titled 'UK Solvency II contacts' with a link to 'Contact our Solvency II experts in the UK'. Below this is a 'Solvency II' section with links to 'Solvency II = solved', 'Model Validation', 'Programme Assurance', 'Our Perspective', 'Pillar 2 Embedding', 'Data and systems', 'Structuring and Groups', 'Programme Support', 'Lifting the lid on Solvency II', and 'Solvency II: What You Need to Know'. At the bottom, there is an 'Our view' section with links to 'White Paper on Group Supervision', 'Tax newsletter', 'Turning regulation into a strategic tool (PDF, 1,340 KB)', and 'Listen to Jane Portas on Solvency II's effect on international insurance groups'.

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**Solvency II = solved**

"Solvency II represents an opportunity to not only improve insurers' operations, but also develop significant competitive advantage in a challenging market. By cutting through the complexities of regulatory change, we can help them embrace Solvency II and derive benefits across the breadth and depth of their business."

Phil Smart, Head of Solvency II, KPMG

**Our Perspective**

**Inside Track**

**UK Solvency II contacts**

- Contact our Solvency II experts in the UK

**Solvency II**

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- Model Validation
- Programme Assurance
- Our Perspective
- Pillar 2 Embedding
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**Our view**

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# Contacts at KPMG in connection with this document



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