Items to consider in the 2021 Own Risk and Solvency Assessment (ORSA)

The ORSA has been a part of companies' risk management processes for a number of years now. With each passing year, developments at macro, and sometimes micro, level prompt supervisors to comment on areas which they believe warrant closer attention in the ORSA. This briefing note considers aspects that supervisors have recently commented upon, along with other topical areas that companies may find useful to consider when preparing their 2021 ORSA.

Overview

In this briefing note we have considered the ORSA primarily from the perspective of an Irish regulated entity but have also drawn upon experience and examples from across the European insurance industry, with sources such as EIOPA and the Prudential Regulation Authority (PRA) in the UK being referenced.

What supervisors expect

As in other years, there have been various communications from Supervisory Authorities regarding their expectations of a robust ORSA process. We have outlined below some interesting communications that are worth considering when preparing your upcoming ORSA:

- In their September 2020 quarterly newsletter, the Irish Regulator (the Central Bank of Ireland (CBI)) outlined the importance of the ORSA both as a management decision-making tool and as a "*fundamental tool through which to consider, inter alia, the impact of COVID-19…*"[1].

  They noted that even though the specifics of COVID-19 could not be predicted, the ORSA process should address situations that were of a similar impact.

  They also reflected on stronger ORSA processes, which involve firms considering material group links and applying robust risk management and stress testing to these links.

- In December 2020, EIOPA released a consultation paper on their Supervisory Statement on the ORSA in the context of COVID-19[2]. With this statement, EIOPA highlights the importance of the ORSA in giving insight into the potential impact of the COVID-19 pandemic on an undertaking's risk profile, along with effective management of risk to ensure there is sufficient capital to help steer companies through periods of adversity.

- In April 2021, EIOPA issued its opinion on the supervision of the use of climate change risk scenarios in the ORSA[3]. Its opinion sets out EIOPA's expectations to supervisors on how to oversee the integration of climate change scenarios by insurers in their ORSAs, applying a risk-based and proportionate approach.

  The PRA and the CBI have also communicated on the inclusion of climate-related risks in the ORSA and we go into further detail on these in the Climate Risk section of this note.

- The German regulator, BaFIN, noted in their 2020 review of their insurance undertakings' ORSAs that stress testing needed to be more differentiated and analysis of results more in-depth[4]. They found that some companies had failed to define the criteria which they applied when selecting a stress test for a given risk.

  They also found that insurers very often focused on stress tests for individual risk factors – such as equities or spreads – but rarely considered combinations of market and underwriting risk stress tests and only occasionally included reverse stress testing.

- In France, the ACPR pushed out the 2020 ORSA submission date to 31 December 2020 to allow for an assessment of the impact of COVID-19 on the company's financial situation, if applicable, thereby indicating that it deems this to be an important aspect of the ORSA process at the moment.

In the following sections we will delve further into topics highlighted by regulators, such as COVID-19 and climate change, whilst also discussing other topical areas including operational resilience, recovery planning and the Solvency II

1 https://centralbank.ie/docs/default-source/regulation/industry-market-sectors/insurance-reinsurance/solvency-ii/communications/insurance-quarterly-news/the-insurance-quarterly---september-2020.pdf

2 https://www.eiopa.europa.eu/content/consultation-supervisory-statement-orsa-context-of-covid-19_en

3 https://www.eiopa.europa.eu/content/eiopa-issues-opinion-supervision-of-use-of-climate-change-risk-scenarios-orsa

4 https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2020/fa_bj_2007_Ergebnisse_ORSA_VA_en.html

2020 review that may be useful for companies to consider when formulating their 2021 ORSA scenarios.

Covid-19

There are a wide range of factors that are relevant to insurers attempting to understand how COVID-19 has impacted (and will continue to impact) upon their risk profile.

In June 2020, the PRA published results from their COVID-19 stress testing exercise[5] and noted that the sector has remained robust in this evolving situation. They also noted that they expect firms to maintain close monitoring of the additional risks presented by COVID-19, update their risk and capital assessments as the situation evolves, and take appropriate management actions where necessary. Insurers will need to ensure that they actively monitor their central best estimate and adjust for any changes where it is appropriate.

In consideration of the above, Milliman published a paper in July 2020 on how insurers can explore their future exposures to COVID-19 through the ORSA and this paper can be found here. The key message here is that insurers:

- Develop a central narrative around what the next three to five years looks like in terms of the virus itself and the knock-on impacts on the economy, society, and the environment, for example. This can then be quantitatively assessed in terms of the variables that are included within the ORSA forecast.
- Consider which of these variables are subject to considerable uncertainty, particularly those that are most relevant to the insurer's risk profile. For the variables that exhibit the most uncertainty and/or materiality, consider if the variables can be assessed using scenario analysis or other risk assessment techniques.
- Design a set of stresses and scenarios to explore adverse developments, where changes are made to key assumptions and parameters in the areas that exhibit most uncertainty.
- Develop novel scenarios that involve aspects or dynamics that the business has not previously encountered. The scenarios need to recognise the interconnected nature of today's business environment, and so it is important to focus on multi-factor scenarios ahead of single-factor stresses, as this would better simulate the real world.

COVID-19 will undoubtably have an impact on claims experience, with the effects being seen through a different lens depending on the nature of the business, i.e. non-life, health or life insurance business. Companies need to consider whether the claims experience seen over 2020 is a true reflection of the company's claims profile in the near to medium term, the uncertainty around these profiles and how best to reflect these within the ORSA.

Across the industry, the economic fallout arising from COVID-19 is still being understood. A number of factors could influence a company's view on the short to medium-term economic climate. With the various stimulus packages having been put in place by government and central banks, to the roll-out of approved vaccines, each company needs to consider the influences which will impact their specific business and economic outlook and reflect these within their ORSA.

Restricted Dividend Distribution

Arising from uncertainty surrounding the pandemic, regulators have been providing guidance in the area of company dividend distribution over the previous year.

In Ireland, through their COVID-19 Regulated Firms FAQ, the CBI proposes postponement of dividend distributions until firms can forecast their costs and future revenues with a greater degree of certainty, echoing statements by EIOPA and the European Systemic Risk Board on the subject. However, where a firm can form a view, with a high level of certainty, that its financial position facilitates the payment of a dividend, the CBI has proposed thresholds for which a dividend distribution could be made and they fall along the lines of demonstrating "*satisfactory forward looking solvency, liquidity and operational resilience positions in light of the current environment*".

Where companies are proposing a dividend, the upcoming ORSA can be used to demonstrate clearly that the company has the capacity to pay their proposed dividends and meet the CBI's expectations around the areas of solvency, liquidity and operational resilience.

Further to this, the CBI updated its guidance on dividend distribution in February 2021 for "*more significant insurance firms*"[6] (whom they have already contacted directly) stating that proposed dividend payments should not worsen the solvency ratio by greater than 15 percentage points and should be significantly lower than non-COVID year distributions.

Climate

Climate change risk has been a focus of supervisors over the last year, with EIOPA's opinion on the matter as referenced above (in the "what supervisors expect" section of this note) being evidence of this activity.

In its opinion, along with providing practical guidance on the selection and implementation of scenarios, EIOPA outlined two

5 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2020/insurance-stress-test-2019-feedback.pdf

6 https://www.centralbank.ie/consumer-hub/covid-19/faq-for-regulated-firms

proposed climate change risk scenarios that insurers should at least reflect, where appropriate, as follows:

- Scenario where the global temperature increase remains below 2°C, preferably no more than 1.5°C, in line with EU commitments.
- Scenario where the global temperature increase exceeds 2°C.

The International Actuarial Association (IAA) completed a survey of its members on what national regulators are requesting regulated entities to show on climate change in the ORSA and the survey results can be found here. As part of the survey responses, the PRA noted that it:

"expects a firm's scenario analysis to address a range of outcomes relating to different transition paths to a low-carbon economy, and a path where no transition occurs. The scenario analysis should, where appropriate, include a short-term assessment which sets out the firm's exposure to the financial risks from climate change ……. and longer term assessment of the firm's exposure, based on its current business model, of a range of different climate-related scenarios".

The PRA stated that it expects the time horizon of the long-term assessment to be in the order of decades. This is not intended to be a precise forecast, but rather a qualitative exercise used to inform strategic planning and decision making.

They also provided thematic feedback through a "Dear CEO" letter[7], with the main take away being that the PRA expects firms to have fully embedded their approaches to managing climate-related financial risks by the end of 2021.

The CBI also discussed climate related risks and expectations around the ORSA in their September 2019 Insurance newsletter[8] commenting that:

"Where an undertaking has a material exposure to climate related risks, we will expect to see evidence of robust analysis and discussion within the ORSA report. The ultimate aim should be to enable discussion, challenge, and decision making in relation to climate related risks, at board level".

With the number of regulatory communications and the possible impact climate change risk could have on firms over the business planning horizon, it is important for companies that are impacted by climate change risk to ensure both quantitative and qualitative analysis is included in their upcoming ORSAs.

Solvency II 2020 Review

In December 2020, EIOPA published its opinion on the Solvency II 2020 review. This follows on from several consultation papers released in 2019 outlining various proposals to the European Commission covering a number of topics and areas. Milliman has prepared a briefing note summarising EIOPA's final proposals and this can be found here.

It is worth noting that it is now up to the European Commission to adopt, amend or reject the proposals as set out by EIOPA and in its opinion EIOPA notes that the implementation date for any changes is likely to be closer to 2025 than 2020.

The proposals cover a range of areas but, from a Pillar 1 perspective, can be mainly considered as impacting the following calculations:

- Risk-free interest rates
- SCR – interest risk
- Risk Margin
- Volatility adjustment

An alternative extrapolation methodology for the risk-free rate curve has been proposed, moving from a last liquid point (LLP) to a first smoothing point approach, with a weighted average of forward rates before and after the first smoothing point being used in proportion to the liquidity at each maturity. This has the effect of reducing the risk-free interest rates after the LLP (20 years for EUR) when compared to the existing methodology.

Particularly for companies with material long-term liabilities, the impact of proposed changes to the extrapolation methodology underlying the risk-free rate should be considered within the context of the ORSA.

Proposed changes to the interest rate risk module are set to increase the impact of the interest rate down shock for the Euro yield curve and should again be considered by companies that are significantly impacted by this directional movement.

The proposed changes to the Risk Margin calculation would impact upon practically all companies' technical provisions, and companies with a larger Risk Margin may wish to bring these considerations into the ORSA for consideration.

EIOPA's proposed revision to the ratio used in the volatility adjustment could be considered in the ORSAs of those companies currently applying it.

Link with Recovery Plans

With the CBI releasing its consultation paper in June 2020 on proposed regulations for pre-emptive recovery plans (a Milliman briefing note covering this consultation paper can be

[7] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2020/managing-the-financial-risks-from-climate-change.pdf

[8] https://www.centralbank.ie/docs/default-source/Regulation/industry-market-sectors/insurance-reinsurance/solvency-ii/communications/insurance-quarterly-news/the-insurance-quarterly---september-2019.pdf

found here), this serves to underline the importance of recovery plans being embedded in a company's Risk Management Framework. Naturally, there will be links between the recovery plan and the ORSA process.

Against this backdrop, the regulator might well expect to see a degree of consistency between the scenarios that are explored in the recovery plan and those chosen for the ORSA, with the area of most overlap being reverse stress testing. At least some recovery planning scenarios are likely to be more onerous than what would typically be included in the ORSA. Depending on whether or not a company has recently developed (or is in the process of developing) their recovery plan, the process of choosing the recovery scenarios may also form the basis for formulating ORSA scenarios.

Companies could also consider the metrics used to monitor their overall financial strength and resilience within the ORSA (for example SCR, liquidity, and profitability KRIs) and how they link in with the recovery indicators the company has chosen for their recovery plan. There should be an alignment here, with companies generally using their risk appetite statement as a driver for their chosen recovery indicators.

Where scenarios in a company's ORSA result in a possible recovery situation, the ORSA could reference the recovery plan and draw on its proposals for possible recovery actions in order to return the company to a position of strength.

Operational Resilience

A common theme that runs through a number of regulators' communications, consultation papers and statements over the previous year is around operational resilience.

In March 2021, the PRA, in conjunction with the Bank of England and Financial Conduct Authority, released its Statement of Policy on operational resilience[9], following its December 219 consultation paper on operational resilience and impact tolerances for important business services[10], with the aim to improve the operational resilience of firms and protect the wider financial sector and economy from the impact of operational disruptions.

In their communications around dividends, the CBI highlight the need for (amongst other things) satisfactory operational resilience before considering a distribution. With their proposed regulations on recovery planning, the CBI is proactively engaging with companies as to how they monitor operational resilience and ensure a playbook is in place if a company's operations are threatened.

More recently, with their consultation on cross-industry guidance on outsourcing[11] published in February 2021, the CBI has highlighted the risks around outsourcing and the potential influence these arrangements can have on a company's operational resilience.

Although not specifically referenced in any regulatory communications, from the perspective of the ORSA there are a number of questions which may be useful to consider when looking at operational resilience, including:

- Under scenarios which do not consider operational risks (e.g. market risk scenarios), is there any second-order operational strain which might impact upon operational resilience?
- Are there particular operational risk scenarios which might threaten or disrupt important business services?

With the pandemic drawing particular attention to operational resilience, the ORSA process can be a useful place to consider a company's resilience both qualitatively and quantitatively, under both company-specific and macro-level stress scenarios.

Other Considerations

EMERGING RISKS (INCLUDING CYBER)

A company's ORSA exercise can be an opportune environment in which to consider emerging risks.

The CBI has underlined the importance of the ORSA in considering emerging risks, commenting on the area in their September 2020 insurance newsletter[12]. The regulator also issued an emerging risk survey and flagged two areas for particular consideration: climate risk (including flooding) and cyber underwriting risk. Cyber underwriting was also incorporated into EIOPA's supervisory convergence plan for 2020[13] released in February 2020.

The ORSA exercise can be used by a company to test what might happen if a given emerging risk actually emerges, with a possible focus on the areas of climate and cyber underwriting risk (to align with the CBI's focus), if these have yet to be considered.

LIQUIDITY

In March 2020, the PRA released a supervisory statement on their approach to supervising liquidity and funding risks[14]. As part of this statement the PRA provided guidelines on liquidity assessment stress testing, indicating that companies should consider:

9 SoP 'Operational resilience' (bankofengland.co.uk)

10 https://www.bankofengland.co.uk/prudential-regulation/publication/2018/building-the-uk-financial-sectors-operational-resilience-discussion-paper

11 https://www.centralbank.ie/publication/consultation-papers/consultation-paper-detail/cp138---consultation-on-cross-industry-guidance-on-outsourcing

12 https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/insurance-reinsurance/solvency-ii/communications/insurance-quarterly-news/the-insurance-quarterly---september-2020.pdf

13 https://www.eiopa.europa.eu/content/eiopa-identifies-supervisory-technology-pensions-and-cyber-underwriting-new-supervisory_en

14 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2020/ss2415-update-sep-2020.pdf

- Severe but plausible stress scenarios
- Impact on cash flows, liquidity resources, profitability, solvency, asset encumbrance and survival horizon
- A macroeconomic stress
- Impact of deterioration in the firm's credit rating
- Previously liquid markets becoming unexpectedly illiquid
- Ability to transfer liquidity across entities, sectors and countries if applicable

Where a company has identified liquidity risk to be potentially material, the above scenarios and considerations could be incorporated into and evaluated within the ORSA.

BREXIT

With the United Kingdom having withdrawn from the European Union on the 31 January 2020 and the subsequent transition period having expired on the 31 December 2020, cross-border companies selling into the UK Insurance market have had to consider what "Brexit" means for their business model and what steps need to be taken to ensure access is maintained into the UK market going forward.

Companies may have considered the Temporary Permissions Regime (TPR) in order to continue operating in the UK within the scope of their previous passporting permission for a limited period after the end of the transition period, along with branch setups within crown dependencies (i.e. Isle of Man, Jersey and Guernsey) in order to maintain market access.

With possible business re-organisation and operational resilience risks arising from whichever course of action is ultimately taken by the impacted companies, the ORSA can be an invaluable exercise in considering the impact of possible strategies and the risks attached to them.

Summary

Regulators continue to be vocal on the important role the ORSA has within a company's risk management framework and this note highlights some areas of interest to regulators which we have flagged for companies to consider when preparing and reviewing their ORSA.

The areas discussed in this briefing note are not meant to be an exhaustive list but used more so as an aid for discussion within companies (including at board-level) on further development of the ORSA in the near-term.

How Milliman Can Help

Milliman has a wealth of risk management experience in Ireland, including the development and review of risk management frameworks, as well as involvement in all aspects of the ORSA process. We regularly participate in industry events and are we have built a reputation for risk management expertise. We chair the quarterly Insurance Ireland Milliman CRO Forum, which is a roundtable event bringing together CROs from across the Irish insurance and reinsurance industry. We are also well represented on the ERM Committee of the Society of Actuaries in Ireland.

In Ireland, we currently carry out the Head of Actuarial Function role for a wide range of insurers and reinsurers. This role involves close correspondence with the CBI on an ongoing basis, particularly in the context of our involvement in full risk assessments, thematic reviews and other regulatory engagement in helping our clients. As such, we have a unique insight into what companies and the CBI see as the key issues to be considered as part of the ORSA process and related best practice.

Our consultants have undertaken a range of work for clients across all three Pillars of Solvency II. In relation to the ORSA in particular, this includes:

- Design and implementation of Risk Management Systems and ORSA;
- Extensive experience of modelling projected balance sheets, technical provisions and SCR calculations;
- Independent review of Solvency II balance sheet, technical provisions and SCR.
- Assessment of standard formula appropriateness;
- Assessment of own solvency needs;
- Review and gap analysis of ORSA;
- Operational risk modelling.

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