MILLIMAN BRIEFING NOTE

ORSA: Key Considerations for 2017

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Introduction

At this point companies have been through the ORSA process on a number of occasions and will to some extent consider it as "business as usual". However, given that we now have greater clarity on supervisors' expectations of the ORSA – including the risks to be addressed – it is worthwhile spending some time ensuring that your company's 2017 ORSA is in line with best practice in terms of both format and content.

What do Supervisors expect in 2017?

Over the past year or so there have been various communications from Supervisory Authorities regarding their expectations of a "good" ORSA. Many of these communications largely reiterate the Solvency II requirements (e.g. the need to cover all risks, the minimum contents required of the ORSA policy and ORSA report etc.) but there have also been some interesting communications which are worth considering even if not directly applicable in your territory:

- In Italy, the insurance supervisor IVASS issued a letter to companies in April 2017 regarding the scenarios to be included in the ORSA. In this communication it was advised that, given that the 2016 European Insurance Stress Test highlighted the vulnerability of companies to persistent low interest rates and increases in credit spreads, the ORSA should include scenarios similar to those included in the Stress Test – or else state why the company isn't exposed to such risks.

- Similarly, in France, the ACPR[1] ORSA feedback encouraged life companies to consider scenarios involving prolonged declining interest rates, but also the risk of a sharp rise in interest rates.

  The ACPR also stated that it is desirable for companies to not only project their SCR as part of the ORSA but also their MCR, in particular in situations where the organisation is projected to have difficulty meeting the SCR.

  It is clear from the feedback that the ACPR also views reverse stress testing as good practice as part of the ORSA. This echoes the explanatory text within the EIOPA ORSA guidelines which also clearly point to an expectation that reverse stress tests be included as part of the ORSA.

  It is also noteworthy that the ACPR expects concrete actions to come out of the ORSA process, such as improvements to companies' risk management systems.

- In the UK, the Prudential Regulation Authority issued Supervisory Statement SS19/16 in November 2016[2] which included a number of recommendations for improvements to ORSAs including, but not limited to, the following:

  - A good ORSA report should:

    - Include a clear summary
    - Highlight the key outcomes
    - Not be too long (although no indication was given of what "too long" means)
    - Signpost supporting documentation
    - Evidence board sign-off and the key conclusions and actions agreed

  - In order to demonstrate the embedding of the ORSA in the company, companies were "encouraged" to introduce an "ORSA dashboard" which would contain high-level management information presented visually (and including tables, charts and key messages) which would be kept up to date and which would allow the company to revisit key decisions, analyse the risk profile etc. on a periodic basis.

  - The business plan underlying the ORSA projections should include a reasonable rationale for the strategies the company is pursuing to meet its objectives.

- In Gibraltar[3], the Financial Services Commission issued quite an extensive and useful document which highlighted similar themes to those raised by the PRA, including the need for Board involvement to be evidenced in the ORSA report and the need to improve the level of business plan details included in the report. This document also includes a list of scenarios to consider.

- In Ireland[4], the Central Bank ("CBI") issued a letter to companies in May 2016 which was a follow up to previous feedback provided to companies in 2015 on the Forward Looking Assessment of Own Risks. The key recommendations included:
  - The need to explain the appropriateness of the capital buffer in determining the overall solvency needs
  - The need to give sufficient consideration to future material changes in the risk profile
  - A recommendation that reports should be more concise

[1] The "Autorité de Contrôle Prudentiel et de Resolution" (ACPR) is responsible for supervising the banking and insurance sectors in France.

[2] http://www.bankofengland.co.uk/pra/Documents/publications/ss/2016/ss1916.pdf

[3] http://www.fsc.gi/uploads/legacy/download/adobe/2016ORSAFeedbackDocument.pdf

[4] https://www.centralbank.ie/docs/default-source/Regulation/insurance-reinsurance/solvency-ii/requirements-and-guidance/dear-ceo---2015-flaor---may-2016.pdf?sfvrsn=4

- An expectation that the time between the reference date and the consideration of the report reduces from that observed in 2015 where it exceeded 6 months for some companies.

More generally, EIOPA has this week issued a supervisory statement (found here) providing feedback on ORSAs completed in 2016 based on the observations of the National Supervisory Authorities. As would be expected, this feedback is consistent with the feedback noted above with the key recommendations being to:

- *Improve Board involvement in the ORSA process and to better reflect and embed ORSA results in strategic management decisions.*
- *Expand the risk assessment to include all potential material risks (both quantifiable and non-quantifiable) including group risks, operational, emerging and potential cyber risks.*
- *Improve the assessment of how the undertaking's risk profile deviates from the assumptions underlying the standard formula and to place less reliance on the standard formula when determining the overall solvency needs, focusing instead on the undertaking's own risk profile.*
- *Improve the quality of stress tests and to include reverse stress testing.*

Risks to Consider

In recent months Cyber risk and Brexit have received much attention and it is worthwhile ensuring that appropriate consideration of the likely impact of these risks is included in your 2017 ORSA (if not considered previously). As each company will be impacted to a different degree, and there will be numerous knock-on effects from these risks, firms will need to take a holistic approach to determining the likely impacts specific to their company from the realisation of these risks. This will then lend itself to consideration as to whether the scenarios currently included in the ORSA are appropriate and/or sufficiently severe or to whether new scenarios should be considered.

CYBER RISK

Cyber risk is particularly topical at the moment following the outbreak of the so-called "WannaCry" ransomware which blocked access to hundreds of thousands of computers and caused chaos around the globe on Friday 12th May.

Cyber risk is on the agenda of the CBI on a number of fronts. The CBI's Cross Industry Guidance in respect of Information Technology and Cybersecurity Risks (Sep 2016) states that: "*Firms should assume that they will be subject to a successful cyber-attack or business interruption*".

Speaking about the ORSA at the European Insurance Forum in March 2016, CBI Director of Insurance Supervision Sylvia Cronin stated that: "*We've seen better discussion, assessment and, where relevant, planning for risks, whether it be in global risk categories, such as operational or strategic risk or in specific and emerging risks, such as cyber risk.*"

In an address to the Society of Actuaries back in September 2015, then CBI Deputy Governor Cyril Roux stated that: "*The next big financial shock will arise from a succession of successful cyber-attacks on financial services firms*".

Comments such as these show just how seriously the CBI takes the threats posed by cyber risk. Furthermore, an EIOPA stakeholder sub-group is currently examining cyber risk and companies should look out for any communications arising from this group's activities.

Practice regarding the treatment of cyber risk as part of companies' 2017 ORSA will no doubt be varied. Some companies may choose to address cyber risk from a qualitative perspective only, while others may consider including financial projections in order to analyse the possible impacts which would arise due to a cyberattack.

As noted previously, it is advisable to work through both the practicalities and the financial implications of a cyberattack on your company as the consequences can be far-reaching including:

- Disruption to systems leading to processing delays, lost business opportunities, wasted resource time etc.
- Reputational damage leading to increased lapses and falling volumes of new business.
- Additional costs such as:
  - Software and technical support to get rid of the infection.
  - Paying potential regulatory fines. Under the General Data Protection Regulation ("GDPR"), which comes into force in May 2018, companies could be fined up to a maximum of €20 million or up to 4% of the total worldwide annual turnover of the preceding financial year (whichever is higher) for a data protection breach.

Given the potential to cause severe financial stress, it is no surprise that companies are examining options such as purchasing cyber insurance, contracting experts to try to penetrate the company's systems to identify weaknesses and increasing the sophistication of capabilities to prevent such attacks from being successful.

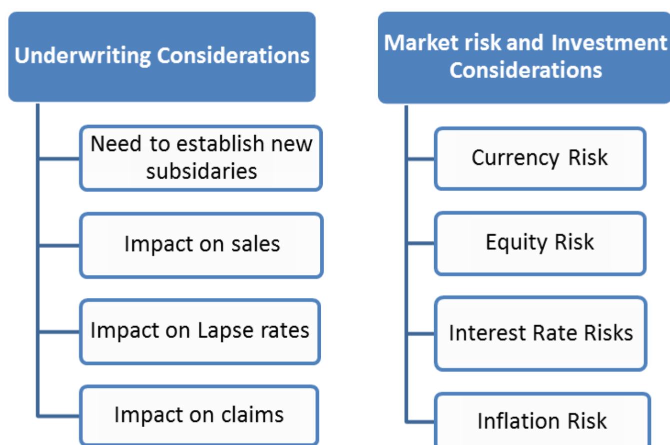
BREXIT

As we all know, last year, the UK voted to leave the European Union, paving the way for a so-called 'Brexit'. Almost a year after the vote, it is still not 100% clear what a Brexit will actually entail. There has been a general consensus that there will be a 'hard Brexit' with the UK leaving both the EU's Single Market and customs union, although this is somewhat less certain

following the unexpected results of the June 8th UK general election. Brexit could impact (re)insurers in a number of different ways.

Again, consideration will need to be given to the likely impacts of this on your company such as those outlined in the following figure:

Figure 1



The need to establish subsidiaries would arise for EU firms wishing to access the UK market or for UK firms wishing to access the EU market in the event that the UK leaves the single market. Many of the other underwriting considerations could arise if a recession is assumed to arise as a result of Brexit. For example, falling disposable incomes could lead to an increase in lapses rates and falling new business volumes whilst a recession is also associated with an increase in fraudulent claims.

Market turbulence is also to be expected due to the level of uncertainty at present.

Other Considerations

There are a number of other recent developments that (re)insurance companies may wish to consider as part of the 2017 ORSA process:

- EIOPA has recently reviewed the methodology used to determine the Ultimate Forward Rate ("UFR"). The Euro-related UFR will fall from 4.2% p.a. currently to 4.05% p.a. in 2018. Companies for which the UFR is an important assumption may wish to consider the fall in the UFR in 2018 (as well as any further anticipated falls) in the financial projections prepared as part of their ORSA.
- EIOPA has also recently issued a discussion paper on the calibration of some of the standard formula stresses used in determining the SCR. Companies may need to consider the potential for changes in these calibrations and the impact that these may have on capital requirements5. For example, the mortality and longevity risk sub-modules are to be recalibrated and EIOPA have put a stochastic model forward for discussion. It is unclear what impact such a model would have on the resulting standard formula shocks. In addition, possible changes to the standard formula could have implications for companies' assessments of standard formula appropriateness.
- The final standard for IFRS 17 was published in May 2017. From 2021 there will be a change in the way that (re)insurers prepare their financial statements for insurance contracts. This will have implications for the reporting of profits and the calculation of tax payments. Furthermore, in the build up to the go-live date, companies will need to undertake implementation projects which may result in additional costs in the coming years.
- Over the past few years the OECD and G20 countries have been developing a framework to tackle Base Erosion and Profit Shifting ("BEPS") (where profits are artificially shifted to low or no-tax locations where there is little economic activity). This new framework tries to establish where profits are earned and should therefore be taxed. There may, therefore, be implications for cross-border (re)insurers that are worthy of consideration in the ORSA.
- We have already discussed the Brexit implications which companies may wish to consider. However, geopolitical risk more widely is something that companies may also assess in greater depth as part of their 2017 ORSA. As the Brexit vote results proved, volatility in financial markets, as well as major impacts to the ability of certain companies to continue to trade in their current form, can ensue following political results and companies should be mindful of these risks also.
- In terms of a longer time horizon, companies may wish to begin considering emerging risks such as climate change (which could affect claims, particularly in relation to non-life catastrophe events) or the impacts of technological advances affecting how insurance cover is underwritten, bought and sold (e.g. the impact of new market entrants focussing solely on internet sales).

[5] Further information can be found in the EIOPA discussion paper https://eiopa.europa.eu/Publications/Consultations/EIOPA-CP-16-008_Discussion_Paper_on_SII_DR_SCR_Review.pdf and in our briefing note on this topic http://www.milliman.com/uploadedFiles/insight/2017/EIOPA-discussion-paper-review-Solvency-II-Delegated-Regulation.pdf.

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 over 20 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.

GLOBAL NETWORK

Milliman has 61 offices worldwide, with more than 3,000 employees, providing a comprehensive network to deal with any business needs that may arise.

With over 250 consultants and 12 offices spread throughout Europe, Milliman is ready to assist with new application queries related to any territory.

EUROPEAN MILLIMAN LOCATIONS

Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

EXPERTISE AND EXPERIENCE – SOLVENCY II

Our consultants have been involved in advising our clients on Solvency II issues since its conception. We 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.

Milliman also has a range of software available to support companies in the ongoing Solvency II requirements including:

- Solvency II Compliance Assessment Tool (link)
- Milliman Star Solutions - Vega®: An automated Pillar 3 reporting and standard formula aggregation system (link)
- Milliman Star Solutions - Navi®: A liability proxy modelling tool (link)

As a result, we have a wide range of experience that can be brought to bear to benefit your business.

For more information contact your usual Milliman contact or one of the contacts listed below.

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