

## **Risk Management Task Force<sup>1</sup> of the Standards Project Team**

### **Draft Proposal to Develop a Standard on ORSA under Solvency II**

#### **0 Executive summary**

At the Vilnius committee meetings last April the Risk Management Task Force (RMTF) was requested to develop a proposal for consideration by the SFPC at its next meeting in Helsinki in October on a potential ORSA related European Standard of Actuarial Practice (ESAP). The RMTF has worked out this draft proposal based on the relevant documents produced by the AAE and the IAA and on our own knowledge and experience with standards and particularly with ORSA and its legislative foundation. We have exposed and received comments from the Standards Project Team (SPT) and informally from the Chairman of the Actuarial Standards Committee of the IAA.

Based on our consideration we recommend

- the immediate addition of the development of the AAE model standard on ORSA to the Standards Work-Plan;
- that the AAE should start work on the development of an European Actuarial Note (EAN) on ORSA;
- that during the development of this ESAP the AAE should cooperate closely with the IAA in order to avoid any potential future confusion around an ORSA standard.

The underlying reasoning for the above recommendations can be found in Section 3 Considerations; and a more detailed form of the above recommendations can be found in Section 4 Conclusion.

#### **1 Background**

The RMTF presented a Discussion paper<sup>2</sup> on potential development of three ESAPs on risk management<sup>3</sup> at the committee meetings of the AAE in Vilnius last April. In the Discussion paper the RMTF reviewed the legislative, internal, and other available external documents that relate to the standard-setting process that were deemed to be relevant for our task. There were fruitful discussions at the Standards, Freedoms and Professionalism Committee (SFPC) and the Insurance Committee (IC) on this Discussion paper. Some concerns were raised regarding the speed of development of international (IAA) and European standards and some committee members also questioned the wisdom of introducing risk management standards at this point in time, whereas others warmly welcomed such a development. The

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<sup>1</sup> Annex 2 includes the names of the members of the Risk management Task Force

<sup>2</sup> See Annex 8 of the Agenda of the Vilnius meeting of the Standards, Freedoms and Professionalism Committee on 24 April 2014

<sup>3</sup> The role of the actuarial function in contributing to the risk management system under Solvency II; Actuarial practice in relation to internal models under Solvency II; Actuarial practice in relation to the ORSA process under Solvency II

SFPC requested the SPT and the RMTF to deal with the three topics presented at the meeting using a step by step approach: the first priority should be the standard in relation to ORSA under Solvency II. The two other potential standards should only follow after an interval in order to allow Member Associations time to digest the European ORSA standard and potentially two IAA model standards<sup>4</sup> in the area of risk management.

## **2 Terms of Reference (ToR)**

The ToR of the Risk Management Task Force were amended. The revised tasks include the following

- 2.a Develop a proposal for consideration by the SFPC regarding the possible development by the AAE of ESAP3 in relation to the role of actuaries carrying out work for the Own Risk and Solvency Assessment (ORSA) of an insurance entity or group under Solvency II;
- 2.b Consider to what extent the desire to promote the role of the actuaries in the risk management function and in the preparation of the ORSA could be addressed by guidelines or actuarial educational material as opposed to a formal model standard.

## **3 Considerations**

The RMTF acknowledges that compliance with professional standards incurs costs and places duties on the practising actuary. Some may consider the burden of compliance with actuarial standards as a disadvantage for an actuary who is a member of a Member Association of the AAE compared to an expert who is not subject to professional standards. However, the RMTF believes that there are also considerable advantages resulting from members of the actuarial profession being subject to standards, such as gaining trust and confidence in the services provided by members of the actuarial profession, in Member Associations and in the AAE<sup>5</sup> by firms, regulators and other stakeholders, including the public at large. The RMTF believes that the advantages of having actuarial standards far outweigh the disadvantages<sup>6</sup> and this applies to risk management related standards and, in particular, to a standard relating to carrying out an ORSA.

ORSA is a process that requires the contribution of a number of experts within an insurer (reinsurer) or an insurance group. Beyond the contribution of the actuarial function, which is responsible for the coordination of the technical provisions, other experts need to be involved in the assessment of risk, the projection of the Solvency II balance sheet and the SCR/MCR, designing stress scenarios, etc. Firms and regulators are expected to place more trust where actuaries perform such activities subject to professional standards than those where such complex tasks are executed with no consideration to professional standards. As firms will have to disclose a description of the system of governance and an assessment of its adequacy for the risk profile of the undertaking in the solvency and financial condition report, this distinction may have an effect on the general public through analysts' opinions. Hence we believe that development, adoption and the actual application of an ESAP on ORSA will contribute to high quality actuarial services, to confidence in such services and

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<sup>4</sup> The primary purpose of a "model standard" is that member associations of the AAE or IAA (actuarial standard-setters) consider the guidance therein and adopt/adapt the standard to suit their membership. The resulting standard (which is no longer a "model standard" but a standard to be applied by individual actuaries) should be consistent with the "model standard".

<sup>5</sup> Partly the reason some major external stakeholders, like EIOPA, do not consider the actuarial profession well established is the fact that our profession does not have a set of professional standards internationally.

<sup>6</sup> The AAE (then Groupe Consultatif) went through a general discussion in 2010 and 2011. Finally the General Assembly has concluded in the Prague meeting in autumn 2011 that the GC should develop S II related model standards provided that these meet the criteria mentioned in our Proposal paper.

thus to serve the public interest, and to promote the role of actuaries in the Risk Management area.

The internal background document of this Proposal for Development of a Standard is the AAE paper titled *Purpose of standards and criteria to be met* (approved by the General Assembly on 21 October 2011 in Prague). “The overriding purpose should be to serve the public interest by ensuring that the users of actuarial services benefit from a high quality of actuarial work. The principal purposes of ESAPs should be:

- 3.a to enhance the quality of delivery of professional services by actuaries;
- 3.b to help to ensure that the actuarial work product meets the needs of users of actuarial services;
- 3.c to enable actuaries to play an enhanced role in the protection of policyholders and beneficiaries through the quality of the advice given;
- 3.d to contribute towards the development of consistency of actuarial practice across the EU; and
- 3.e to provide guidance to actuaries on good practice.”

According to the paper, the concrete criteria to be met by a proposed standard are as follows:

- 3.1 The proposed standard relates to actuarial work which has common characteristics across the EU and hence it is more efficient for the AAE to develop a model standard than for each member association to develop a standard independently and by applying a harmonized approach stakeholders can be expected to have more confidence in the professional services provided by actuaries.
- 3.2 There is no conflict or overlap with an IAA standard, unless there are specific circumstances in EU which justify the differences.
- 3.3 The proposed standard does not conflict with the legal or regulatory requirements, or with standards or guidelines set by another regulatory or supervisory body at the European level, to which actuaries are also subject.
- 3.4 The proposed standard would serve as a significant point of reference for the actuarial profession in relation to other professions and regulators.

By developing an AAE model standard on actuarial practice in relation to the ORSA under Solvency II, all principal purposes of ESAPs as mentioned above would be met, as the proposed ESAP would

- a. enhance the quality of delivery of ORSA-related services provided by actuaries;
- b. help to ensure that the actuarial work product in relation to ORSA meets the needs of users of actuarial services;
- c. enable actuaries to play an enhanced role in the protection of policyholders and beneficiaries through the quality of the advice given for the ORSA process;
- d. by promoting adoption of the AAE model ESAP by Member Associations, contribute towards the development of consistency of actuarial practice across the EU; without an AAE model standard there is the risk that the variety of undertaking and country specific ORSA approaches would be far wider than necessary and that the objective of consistency would be harder to meet later on; and
- e. provide guidance to actuaries on good practice in ORSA-related services; there is not much experience existing yet in the field of ORSA thus there is high need to provide guidance to actuaries.

and

- 1. (Common characteristics) It would clearly be more efficient for the AAE to develop an AAE model standard on ORSA under Solvency II than for each standard-setter (Member Association) to develop such a standard independently.

2. (No conflict with IAA standards) Currently it is not envisaged by the IAA to develop an ISAP on ORSA. The use of ORSA by undertakings has been spreading around the world but there is no identified common root of the practices in various parts of the globe. However, this commonality exists as a consequence of the Solvency II framework in Europe.
3. (No conflict with legislation) The ORSA standard will be based on the Solvency II legislation.
4. (Significant point of reference) If professional standards in relation to ORSA, and generally in relation to risk management (RM), in the context of Solvency II were deemed to be beneficial for the users of the RM services, then it would be of utmost importance for the actuarial profession in Europe to establish ESAPs in relation to RM in the context of Solvency II. Using this approach, actuarial services in this area become subject to ESAPs (or the standards that standard-setters, i.e. Member Associations, issue on the basis of the AAE model ESAPs) and not standards set by non-actuarial organizations beyond the reach of the profession<sup>7</sup>.

The RMTF believes that it would be very timely for the AAE to start developing an AAE model standard on ORSA. There are three main reasons why the AAE should act now.

- 1) Solvency II will shortly be implemented across Europe. The harmonized implementation requires harmonized AAE guidance for actuaries providing actuarial services in relation to ORSA under Solvency II.
- 2) The AAE should act promptly to develop AAE guidance for actuaries providing actuarial services in relation to ORSA so that such services are subject to such an ESAP rather than to no standards at all or to standards set by non-actuarial organizations beyond the reach of the profession<sup>7</sup>. Actuaries working on the ORSA process will be better equipped to do their job subject to and supported by such a standard. Furthermore, external stakeholders such as employers and regulators/supervisors would most probably place more reliance and give more credibility to actuaries subject to such a professional standard than to other experts without the need to comply with such professional standard.
- 3) Because the ORSA-related standard is envisaged to be confined to actuarial services under Solvency II, the area of practice is sufficiently narrow.

The RMTF believes, consistent with the request made at the Vilnius meeting of the SFPC, that at this point in time the production of an ORSA-related standard would be most timely and would best serve the public interest and actuaries in Europe. The AAE should develop its ESAPs step by step in the area of RM and other such standards may be developed in the future. The Solvency II legislation and guidance, itself in a stable and nearly final form, provides a sound foundation for the ORSA via guidance specifically on the ORSA as well as guidance which will be applicable to aspects of the ORSA. Although we expect the actuarial theory and practice around the ORSA to continue to develop, the Solvency II context serves as sound and stable foundation upon which to base the principles forming this ESAP.

The ORSA process under Solvency II is one of the most important RM processes combining the requirements of a number of types of expertise including actuarial. It will be applicable for all insurers and reinsurers subject to the Solvency II regulation. For developing, implementing, operating, reporting on, using, monitoring, reviewing and updating the ORSA process there will be a number of tasks that actuaries are well-placed to carry out in relation to providing the quantitative parts of the ORSA process. These include stress and scenario tests, as well as an assessment of a forward-looking capital adequacy under an economic view and under the Solvency II regulation.

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<sup>7</sup> This argument was formulated by Gabriel Bernardino, Chairman of EIOPA, at the meeting with Groupe Consultatif officers on 11 December 2013 in a strikingly simple way in commenting our efforts to explore development of risk management related actuarial standards: "If you do not do this, somebody else will".

It is important to emphasize that the RMTF does not envisage a prescriptive standard that would dictate what the actuary must do in relation to ORSA and how to do it; rather, in order to allow various sound approaches, the ESAP in relation to ORSA should provide guidance in the form of principles to actuaries about what they should do or should consider doing (in the context of ESAP1) when providing actuarial services in relation to ORSA. Such guidance

- needs to have widespread practical relevance;
- needs to be primarily actuarial in nature;
- should enable the actuary to draw upon actuarial standards as well as best practices in risk management
- should not conflict with legislation or other applicable standards (such as EIOPA guidance or other ESAPs);
- should not limit innovations in actuarial theory and practice in relation to ORSA; and
- should not restrict practice inappropriately relative to what a non-actuary providing services in relation to ORSA could do.

Thus such an ESAP needs to be principles-based and concise and should not include material of an educational nature.

However, the RMTF believes that the European actuarial profession could benefit from an educational paper (an EAN) that through descriptions and examples of good practices gives an overview of what might be used by actuaries in implementing the ORSA standard or when providing actuarial services in relation to ORSA. Such an EAN should contain non-binding, educational material.

#### **4 Conclusion**

Different stakeholders have various needs involving actuarial services under Solvency II. Creditors, investors/shareholders and rating agencies want clarity and reliability; regulators/supervisors and auditors require reliability, transparency and compliance; policyholders want reassurance; policymakers want policyholder protection, sound industry operation and contribution by the industry to economic stability and sustainable growth. Internal stakeholders have additional needs: the board of directors (AMSB) requires usability, reliability and clarity; the risk management function requires support, collaboration, education and timeliness. To address these (and perhaps some other) needs in a balanced way, actuaries working with the ORSA process under the Solvency II framework may find it eminently useful to have at hand the appropriate guidance in the form of a European actuarial standard.

To meet the needs mentioned above and other needs which may be identified during this process, the proposed ESAP is intended to serve as a common starting-point for actuaries in Europe, supported by principles and principles-based frameworks, which will enable and support actuaries in the provision of actuarial services and ensure that the users thereof may place a high degree of reliance thereon.

The RMTF recommends the immediate addition of the development of the AAE model standard on ORSA to the Standards Work-Plan, because we believe that the confidence of stakeholders in the quality of ORSA related actuarial services will be supported better compared to no standard or to the development of educational material only.

The RMTF also recommends that the AAE should start work on the development of an EAN on ORSA, in close cooperation with the work of the SPT or the drafting team of the ESAP on ORSA, because EANs are usually of high practical use and developing the ESAP and the EAN parallel will enhance the quality and usability of both.

Even though the IAA does not have an immediate intention to develop an ORSA-related standard, the RMTF believes that during the development of this ESAP the AAE should cooperate closely with the IAA in order to avoid any potential future confusion around an ORSA standard.

It is thought that including the background, purpose and a high level scope description of the ESAP proposed here could help further discussion. An attempt to draft such main ideas can be found in Annex 1. In this annex the proposed content of the EAN is also indicated.

31 August 2014

Gábor Hanák  
Chairperson  
Risk Management Task Force

## **Annex 1**

### **ESAP[3]: Actuarial practice in relation to the ORSA process under Solvency II**

#### **1. Background**

The ORSA process under Solvency II is one of the most important RM processes combining the requirements of a number of types of expertise including actuarial. It will be applicable for all insurers and reinsurers (undertakings) subject to the Solvency II regulation. For developing, implementing, operating, reporting on, using, monitoring, reviewing, updating and documenting the ORSA process there will be a number of tasks that actuaries are well-placed to carry out in relation to providing the quantitative parts of the ORSA process, such as stress and scenario tests, assessment of a forward-looking capital adequacy under an economic view and under the Solvency II regulation.

Many undertakings in Europe have developed or are developing their own ORSA process and some of them are already using it for RM and decision-making purposes. Actuarial expertise plays a central role in the quantitative parts of the ORSA process. With the introduction of Solvency II, the services in relation to the ORSA process—including the development, operation, usage, review of and report on quantitative assessment of risk and applying appropriate (reverse) stress and scenario-testing—that are used by undertakings for their own risk and solvency assessment processes for internal or regulatory purposes are provided by actuaries to undertakings as employees, managers, directors, external advisors, auditors, or regulators/supervisors. Such activities will be regulated by the Solvency II directive and the related legislation and supervisory guidance that will be issued by various European bodies. Further actuarial guidance complementing the regulation and the supervisory guidance and specific to the actuarial services in this practice area would be beneficial to the actuarial profession in Europe and to external stakeholders such as employers and supervisors, as they would most probably place more reliance and give more credibility to actuaries subject to professional standards than to other experts without the need to comply with such professional standards.

It is expected by the Solvency II framework that undertakings will develop and place reliance on the ORSA process that is compliant with sound actuarial principles in the decision-making process on various levels of the undertaking from departments through a solo undertaking to a group. Hence issuing an appropriate AAE model standard that serves as a basis for actuarial standard-setters could greatly raise the trust of users of actuarial services in this area including undertakings, European institutions, national regulators/supervisors and other stakeholders.

#### **2. Purpose**

The purpose of this ESAP is two-fold: to enable and support actuaries in the provision of actuarial services in relation to the ORSA process under Solvency II and consequently that the intended users of these actuarial services (including employers and regulators/supervisors and other stakeholders) may place a high degree of reliance thereon when provided by actuaries compliant with this ESAP. Actuaries who practise within a set of clearly articulated professional standards (including those addressed by this ESAP) will be relied upon more readily by users who want to feel more comfortable regarding the quality of the ORSA process they are dealing with. Thus this ESAP will help in this area of practice the acceptance of, trust in and reliance on actuarial services provided in compliance with a professional standard substantially consistent with the proposed AAE model ESAP.

This ESAP will provide useful and high quality guidance to actuaries when providing actuarial services in relation to the ORSA process of undertakings in compliance with the Solvency II framework. The purpose of this ESAP is to address a need. The actuarial work specific to the ORSA process under Solvency II requires actuarial expertise, theoretical background and understanding of Solvency II guidance. To this end, the ESAP will enable actuaries to balance theoretical soundness and practical needs. Ultimately, the purpose of this ESAP is to be usable.

In providing guidance for the delivery of actuarial services, the ESAP is intended to serve as a common starting point for actuaries in Europe supported by principles and principles-based frameworks.

This ESAP will contribute to ensuring consistent, efficient and effective practices provided by actuaries in relation to the ORSA process across undertakings in the European Union. This will strengthen and contribute towards harmonized and consistent application of EU legislation.

The guidance provided in this ESAP is intended to motivate Member Associations of the AAE and their standard-setters to consider adopting or adapting this ESAP for their membership applying the principle of subsidiarity at the same time.

### **3. Scope, roles and content**

This ESAP will apply to actuaries when performing actuarial services in relation to the ORSA process of undertakings and groups in compliance with the Solvency II framework. For this standard, the ORSA process will be defined by Article 45 and Article 246 (4) of the Solvency II Directive and further detailed in the related legislation and supervisory guidance. All undertakings under the scope of the Solvency II framework will have to meet these ORSA requirements.

This ESAP will apply to actuaries when performing actuarial services in relation to developing, implementing, operating, reporting on, using, monitoring, reviewing, updating and documenting the ORSA process.

At this time, we envisage that this ESAP will focus on the following aspects and considerations of actuarial services in relation to the ORSA process:

- Considerations in relation to the ORSA processes
  - Establishing a structured and documented approach to uncertainty
  - Considerations for consistency with or deviation from Solvency II requirements
  - Considerations for the business planning period and the interactions among risk, capital, and value
  - Involvement of the business in the ORSA processes
  - Risk management and the ORSA
  - Events triggering an ORSA run
  - Effectiveness of the model(s) supporting the ORSA methodology as a risk management tool
- Considerations in relation to the model(s) supporting the ORSA methodology
  - ORSA methodology and structure—connections with SCR methodology
  - Risk coverage considerations for the model(s) supporting the ORSA methodology
  - Combining quantitative and qualitative risks coherently
  - Considerations for stress-testing, reverse stress-testing, and scenario-testing
  - Time horizons: business planning period and risk-specific timeframes
  - Special issues specific to group ORSA
  - Limitations of the model(s) supporting the ORSA methodology
  - Understanding and documenting the key similarities and differences between the real world and the modelled world from an ORSA point of view (i.e. the world implicitly assumed within the model(s) supporting the ORSA)
- Considerations in relation to “Business as Usual” (using ORSA)
  - Entity interactions with business processes and business units
  - The ORSA run: set-up, reproducibility, and documentation

- The ORSA output: the ORSA Report; documentation, use and limitations
- Considerations in relation to Governance
  - Processes for design, use and monitoring
  - Communication and consultation with stakeholders
  - Review and update of appropriateness of methodologies, model structures and model output, including risk coverage of the model(s) supporting the ORSA methodology and emerging risks
  - Review and update of users and uses of the ORSA output and the suitability thereof considering the difference between real world and modelled world

At this time, we envisage that the EAN accompanying the ESAP will focus on the following aspects and considerations of actuarial services in relation to the ORSA process:

- Clarification of ORSA related terminology
- Risk appetite, risk tolerance, and risk profile
- Identification, assessment, calibration, measurement, management, monitoring, mitigating, controlling and reporting on various risks
- Combining quantitative and qualitative risks coherently
- Appropriate “richness” of risk inputs and ORSA outputs
- Appropriate probability distributions of the underlying risks
- Assessment of dependency of risks
- Bases of valuation
- Asset-liability management
- Data quality

## **Annex 2**

### **Members of the Risk Management Task Force**

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