ACTUARIAL ASSOCIATION OF EUROPE

EAN on ESAP3 and ORSA – ED phase ended on 30th Sep – summary of the comments received

Lauri Saraste

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General points

- Some response received from 7 countries where France, UK and Netherlads provided comments on the exposure draft. Germany, Finland, Hungary and Italy approved it without comments
- Highly Valuable comments from the Dutch association, IFoA and Institut des Actuaires.
  - UK's comments might need to be incorporated and this should be rather quick. Some of their suggested changes may take some of the text into the "should" area, but we can fine-tune the wording to avoid this. However, there are aspects where what they suggest actually should be a "should" (i.e. requirements)
  - Some comments received from France that there could be more simple examples and some advises. This seems to be possible but the advises might needs to be written carefully…
  - The Dutch comments were most extensive, some changes can be made fairly easily, some much more structural and would make the EAN look quite different than now. E.g. EAN to be more independent document, make a strong reference to IAA risk book, new chapter on overall description on ORSA, more non-life and group text, more from the policies insurers have to manage the business and their relation to ORSA

Next steps

- The final electronic approval can’t start yet, too much open issues

- Two ideas:

  A. Try to keep the changes minimal and have bilateral discussion with UK, Dutch and French colleagues to find a consensus – by this it could be entered into the electronic approval if there’s not that fundamental changes

  B. Wake up the wg and start making the changes – as the EAN migth change a lot a new ED would be needed but before that the discussions in IC and ProfC as before

- What are the views from IC and Prof C. ?

Specific comments received – not all, just the main messages

French comments - summary

- The paper is really clear and based on the basics of the “Risks”.
- The part 3.2.2 presents several risks for which the probability is not a question. The document could remind at this point that Reverse Stress tests can be used to identify the stress level that is concerning for the company. It can be declined into a warning level and management action trigger.
- The parts 4.2.3, 4.2.4 would be improved by the inclusion simple examples.
- The document could be also improved by including advices on how to present the technical choices underlying the ORSa report to the AMSB.

Dutch comments - summary

- The note is long and difficult to read. – a long summary, the long part on uncertainty and risk and all modelling considerations. Also Some topics seem to be dealt with multiple times.
- The note is not balanced. By this we mean that most topics are covered in one page, but some topics need several pages. suggest to reference to other material
- The note is additional to ESAP3 and should be read simultaneously. suggest to put less focus on this relationship and make the note independent from ESAP3 because of this relationship it is difficult to read and, as not all actuarial associations will adopt ESAP3, but still might want to use this EAN
- We miss the overal description of the ORSA framework and process. As it is educational we strongly suggest to add the framework and overall process as this helps someone not familiar with ORSA with the understanding of it.
- Throughout the EAN the term "the actuary" is used where often it is not clear what is meant by this. The text seems to suggest that the note is written from the view point that actuaries only work in the actuarial function and only have a supporting model development role, but in practise actuaries have different roles in the ORSA,

Dutch comments - summary

- We would encourage to stress in the note that the ORSA is an ongoing part of risk and capital management practices and has merit beyond any regulatory requirement. The focus is now very much on Solvency II compliance and the focus on this compliance is just what makes an ORSA less effective.
- Check the text on textual errors, such as typos and to many spaces between words. Furthermore, be consistent in the use of abbreviations and punctuation marks in summaries.
- The focus of the EAN is on life insurance. We would like to suggest adding more Non Life examples
- The IAA Risk Book chapter contains a chapter on ORSA. It would really add value if both documents are consistent with other, both with their own audience and depth of detail, because then both documents can be used in education and complement each other.

Dutch comments - summary

- We suggest to check the note on completeness as we believe not all important ORSA elements are covered , for example:
  - The purpose of an ORSA. As it is an educational note we believe it is important that the user first understands what the objectives of the ORSA are before going into any details.
  - Identification of key risks, the starting point of an ORSA process
  - Communicating and Reporting of ORSA Results
  - Group considerations
  - No guidance is provided on the composition of capital, although this is an important element of the ORSA. With composition of capital we mean the tier1, 2 and 3 composition and which part of capital is suitable for the SCR coverage. This changes over time and can be different among scenario'sThere is not much guidance on the governance and policies of an insurer. This is an important element of the ORSA. An example is the capital management policy and how the management actions formulated therein are taken into account in the ORSA.

UK comments – key issue

- **Section 4.3.4 ESAP 3: Discount curves**
- The section on Solvency II and assessment of long term credit risks includes the following text: *'With EIOPA providing the risk-free curve and the VA, SII removes the reliance upon credit rating agencies, eliminates the need for in-house "asset valuation",…'* We think this statement is incorrect, and should be amended. Solvency II (SII) seeks to facilitate a *reduction* in the over-reliance of External Credit Assessment Institutions (ECAI). This reduction is not the same as complete removal.
- The calculation of the Matching Adjustment requires the deduction of a fundamental spread. The fundamental spread varies, amongst other things, by a credit assessment of a nominated ECAI. The risk corrected spread determining the volatility adjustment '*shall be calculated in the same manner as the fundamental spread*'. This would imply that the credit ratings from ECAIs are being relied upon.
- In addition, the prevailing low interest rate environment has led to insurers (in the UK and elsewhere) investing in illiquid assets such as commercial real estate. Such assets are not publically-traded and are therefore valued on a mark to model basis. Article 10 of the Commission Delegated Regulation set out alternative valuation methods for assets without a quoted price in active markets.

UK comments - *less substantive points:*

- **Section 3.1.1 ESAP 3: Establishing a structured approach to uncertainty**
- The subsection 'The business planning process and the ORSA' includes the following text: *'Normally, the baseline scenario would be consistent with the business plan, unless the business plan assumptions are considered to be so inconsistent or unrealistic that the resulting ORSA report would be misleading….If this is the case, it may be advised to disclose this, document the reasons for inconsistencies between the baseline scenario and the business case and outline potential implications'.* We are concerned that the above text could be interpreted by the reader as implying that it is not their responsibility to resolve the issue at source (including escalating as appropriate). A business plan, which is often an input into the ORSA, could impact decision-making and affect cash remittances paid to a Group by a subsidiary or Group dividends / debt repayments to external providers of capital. There are therefore prudential consequences to an unrealistic business plan that would affect the firm and its customers, and this would likely be of interest to the firm's regulator(s).
- Additionally, the Solvency II Directive (Article 48(1i)) includes a specific requirement for the actuarial function to support the effectiveness of the risk management function. We would therefore suggest that the tone or messaging of the highlighted text be strengthened to reflect these responsibilities.

UK comments - *less substantive points:*

- **Section 3.1.2 ESAP 3: Deviation from Solvency II balance sheet approach and methodology**
- This section sets out why a firm may want to deviate from the SII balance sheet in the ORSA process. However, our interpretation of it was that the reasons given seemed to be more applicable to Standard Formula (SF) firms; this is not stated explicitly though, and the text infers that it applies to all firms. For example, one of the reasons for deviating from the SII balance sheet/ methodology was 'to facilitate the identification of any and all material risks and exposures…', which we consider to be less relevant for Internal Model (IM) firms, where all material risks would be reflected in the reported Solvency Capital Requirement. Similarly, the default risk arising from (EEA) sovereign bonds is nil for SF firms, but would be modelled if it was material to an IM firm.
- In our experience, a firm's IM forms an input to the ORSA, although it is used primarily to help calibrate the capital risk appetite and more granular risk tolerances/ limits around market risks such as Foreign Exchange rates.
- We think it would useful to clarify which aspects of the text are relevant to SF or IM or both types of firm, as this will help the reader identify which areas are most relevant to their circumstances.

UK comments - *less substantive points:*

- **Section 3.1.4 ESAP 3: Inconsistency with the undertaking's risk management approach**
- We refer to the following text: *'The business strategy considered within the ORSA may also deviate from the company's risk appetite or underwriting policy, for example a strategic plan to achieve greater market share may cause the company to break certain risk limits…'*
- An inconsistency between the business strategy and risk management framework would suggest that the strategic plan or risk management strategy, or both, need reconsidering. The Solvency II Directive (article 44(1): risk management) requires the integration of the risk management system into decision making processes. A firm which ran its business without regard to its risk parameters could likely come under significant regulatory scrutiny, as it would raise questions about the firm's governance and effectiveness of the risk function. We therefore suggest this text be reconsidered.

UK comments - *less substantive points:*

- **Section 4.1.2 ESAP 3: Own Solvency Needs (OSN)**
- 15. We refer to the following text: *'The eventual adoption of additional frameworks by an insurer will be most useful in measuring risk if the additional frameworks are non-binding. One risk regarding an insurer's OSN is the potential for an insurer's assessment methods to become binding if communicated to the regulator. That is, with a binding OSN, the insurer may be prevented from declaring profits or paying dividends if, for example, their OSN suggests a reserve strengthening while all other accounting and regulatory bases are compliant and positive.'*
- We believe this text could discourage the reader from engaging openly with their regulator due to the concern that what they input/ submission could become binding. The SII Directive (article 45(6)) requires firms to inform their supervisory authority of the results of the ORSA. This is not voluntary, and we believe the text above contradicts this. In the UK (for example), there are fundamental rules that require firms to be open with the regulator and to disclose anything relating to the firm that the regulator would reasonably expect.

UK comments - *less substantive points:*

- **Section 4.1.2 ESAP 3: Own Solvency Needs (OSN) (…continues from earlier slide)**
- Furthermore, there is no basis within SII to enable regulators to use the ORSA as a de-facto minimum capital requirement. Article 45(7) of the SII Directive states that *'the own risk and solvency assessment shall not serve to calculate a capital requirement'*. SII does not require firms to obtain prior approval to pay a dividend. The regulator can only intervene where the payment of a dividend would cause the firm to breach its SCR.
- We suggest that the firm should decide itself how it interprets OSN, and what the status of the OSN is. For example, what the firm should do if the OSN were breached; this should then be documented clearly in the ORSA.
- More generally, the EAN refers to *Own Solvency Needs*, whereas the Solvency II Directive refers to *Overall Solvency Needs*. It was not clear to us whether this differing terminology was deliberate or not.

ACTUARIAL ASSOCIATION OF EUROPE

Actuarial House

1 Place du Samedi

1000 Brussels

Belgium

www.actuary.eu

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