Swiss ORSA

Key challenges for implementation and differences to Solvency II ORSA

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Content

Introduction

This short paper is our first in a series of publications on the changes in the laws and regulations for insurance companies in Switzerland. With FINMA's increased focus on revising the Swiss insurance law and regulations we plan to continue keeping you updated on these changes and our perspective on the implications to the Swiss insurance market.

This edition focuses on FINMA's recently released draft circular on "Own Risk and Solvency Assessment" ("ORSA") requirements, which was published on 8 July 2015 for comments and aims to facilitate equivalence with EU's Solvency II requirements. The ORSA process is an integral part of the risk management process of an insurance company and should be embedded in the business planning and strategy.

FINMA Circular 2016/xx ORSA provides highly principle-based guidance in just over six pages rather than detailed instructions on how insurance companies should go about implementing their ORSA process. Insurance companies will no doubt need to interpret and implement these principles in various ways tailored to fit into their organisational structure and risk management systems. FINMA stresses that the principle of proportionality needs to be taken into account and that reinsurance captives are allowed to implement a simplified ORSA.

The Swiss ORSA should be used as an integral part of the business strategy and has to be taken into account in the strategic decisions of the insurer. ORSA is a process to identify, assess, monitor and manage the risks associated with an insurer's business strategy and to determine the own funds necessary to meet the solvency needs.

Although the ORSA circular does not come as a surprise, the implementation effort for the Swiss insurers will be significant if we are to draw any lessons from the experience of the EU peers. This is particularly exaggerated in the light of the tight effective dates. Based on the issued draft, the first filing for category 1 insurance groups is 31 January 2016 and for category 2 and 3 it will be 31 January 2017.

This paper focuses on the main principles as proposed by FINMA, the challenges we see in achieving both, the objectives of (and compliance with) the requirements and finally some of the main differences we see with the existing Solvency II ORSA regulations.

Emel Can Harrison
Partner, Audit & Advisory

Philipp Keller
Partner, Risk and Regulatory Affairs

Colin Forrest
Partner, Consulting Actuarial

1. The Swiss ORSA

The new ORSA circular of FINMA requires the insurer to formulate a comprehensive picture of its "total risk profile" in relation to capital over a longer time horizon.

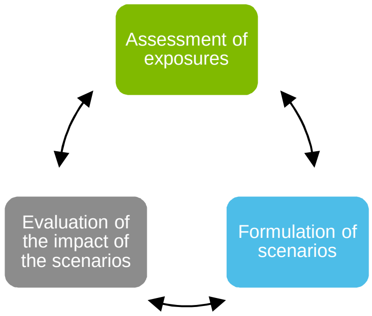
The circular is principles-based and leaves many elements of the implementation to the insurers. However, the circular is clear on FINMA's expectations. Insurers should:

- Formulate an ORSA policy containing the main principles and define the ORSA process.
- Document ORSA both in an internal document and in a report to be submitted to FINMA.
- Make sure that all relevant decision makers within the company are aware of the content of the document.
- Prepare internal documentation to be provided to FINMA upon request.
- Prepare a report to FINMA which contains the results of ORSA and which should be signed by the Board of Directors. The report has to be submitted annually by groups and by insurers of category 1, 2 and 3 by 31 January of each year. Insurers in category 4 and 5 and reinsurance captives have to submit a report only upon a request from FINMA.
- (Groups only) Document the ORSA on a group level, but with sufficient granularity to capture the most important business units and all legal entities that are supervised by FINMA.

The Swiss ORSA is a multi-year view of an insurer's exposure to risk. The time horizon is given by the insurer's planning horizon plus 2 years. Risks to be considered are not only limited to those that are identified and quantified for the purposes of the Swiss Solvency Test (SST), but should include all "relevant" ones including qualitative risks. Due to the longer time horizon of ORSA, insurers have to also consider that their exposures might change as the balance sheet changes due to new businesses or new investments.

As a first step, an insurer has to assess its total risk profile over the time horizon of ORSA. It then has to formulate scenarios that cover that profile and determine the impact on the insurer's balance sheet. The impact has to be measured not only according to regulatory standards (e.g. market consistent) but also according to standards or views that are used for steering purposes (e.g. rating agency standards). The impact assessment also has to take into account possible risk mitigation strategies and the impact of management actions.

The process of assessing the total risk profile, formulating scenarios that cover that profile and determining the impact on the balance sheet is an iterative process as each of the three steps gives insights into the other steps:



The scenarios to be assessed consist of the base-case scenario and optimistic (progressive) ones but also plausible adverse scenarios and at least one that can lead to an existential threat to the insurer. The set of scenarios have to cover the total risk profile of the insurer.

Our expectation is that companies will have to evaluate at least 5 scenarios. A careful formulation of these scenarios and the estimation of the impact on the insurer's balance sheet can be time consuming and complex. Therefore, except for very special cases, it is unlikely that it will be necessary or useful to analyse more than seven scenarios.

The formulation of the scenarios can be complex since the multi-year time horizon can cause secondary effects. An initial event can cause ripple effects over time that will also have to be considered. For example, a scenario of eruption of a volcano can cause a Tsunami that causes the inundation of power plants that cause significant business interruption losses, death and property losses way beyond the immediate impact effect of the volcano.

Equally, the assessment of the impact of a scenario might require the consideration of secondary effects on the insurer. A large loss might cause a downgrade of the insurer which might trigger calls for collateral which in turn might cause a liquidity strain.

Insurance groups or subsidiaries of groups also have to consider the impact of the group structure and usually the complex web of intra-group transactions. ORSA is not an additional capital requirement but a self-assessment by the management team of the insurer. FINMA expects the Board of Director to ensure that ORSA is properly implemented and used for business strategy setting, steering and planning. It is also expected that ORSA is embedded in the decision making process of the organisation.

The complexity but also the usefulness of ORSA lies in the multi-year view. It gives (by complementing the one-year view of the SST) additional insights into the exposures to risks but also into opportunities.

2. Key Challenges

The Swiss ORSA is principle based and allows the insurers to use significant judgement which will be specific to each organisation when it comes to the implementation and controls. We find this to be a positive development as the needs are likely to differ significantly from one company to another. However, this also brings a level of uncertainty, particularly around the question of “How much will be enough?”. Other critical challenges that we see include the following:

- The Board of Directors is expected to understand and use ORSA in their decision-making process and therefore ORSA should be consistent with the Board’s own decision making process and Board-approved business and risk strategies. In addition, corresponding internal controls should be sound and implemented in an effective manner. This will have a critical impact on how the Swiss Boards operate today and also require increased education of the individual board members.

- Developing infrastructure to perform and analyse calculations in tight reporting timeframes has always been a challenge to the existing processes of the Swiss insurers and also require synchronisation between processes aimed for financial reporting, economic capital and regulatory capital management.

- Developing/enhancing integrated capital analysis capability to set risk appetite, risk tolerance and risk limits and embedding those top-down and bottom up.

- Enhancing data environments to support ORSA. Data availability and consistency is one of the most challenging topics for the entire industry. ORSA will require a documented “reconciliation” of the outcomes produced by different data sources for regulatory and economic capital management purposes.

- The production process around ORSA should not be underestimated and the different cycle of production properly anticipated. A critical challenge we see is the particular need to synchronise the “usual” planning process with the ORSA production process. This may well require changes in the planning time line or at the very least a bridge between planning activities (strategy, business, capital allocation and investments) and the ORSA reporting.

- Most Swiss insurers have implemented SST programs, but the main focus of these programs has been on the technical aspects of risk management or, in other words, “quantitative” in nature. When implementing ORSA, insurers will also have to take into consideration the qualitative, governance and controls aspects of risk management.
- The challenge of implementing ORSA confronts insurers as they deal with a difficult environment marked by lower premiums and the sovereign debt crisis in Europe. In addition, Swiss regulatory requirements pertaining to ORSA are (and we expect will remain) based on a few, high-level principles that provide no explicit guidelines for implementation.
- The multi-periodic approach requires sophisticated analysis. Dependencies between the various risks will have to be analysed and potential secondary effects have to be evaluated. The multi-year view also requires the assessment of the impact of management actions, business strategies, risk mitigation measures and more.
- Multi-year approach beyond the normal planning cycle or strategic cycle in our view would also require a process which should look back at “planned” and adjust for differences with actual. This process will now have to take a more structured nature in comparison to the past. Continuous evolvement and iterative processes are expected to emerge as well.
- The implementation period stipulated by the draft circular is very short and will require decisive, pragmatic and speedy implementation. This may be a challenge for Swiss insurers which previously may not have been exposed to Solvency II ORSA requirements. In that regard we would expect a steeper learning curve for these organisations compared to their peers in the EU countries.
- However other companies that are part of EU groups or Swiss groups with EU subsidiaries, which may already have been heavily exposed to Solvency II’s ORSA requirements, will now have to either implement on a standalone basis or ensure a proper “synchronisation” between the two regimes.

It is not all doom and gloom, however. We think FINMA’s principle based approach will help companies adopt a more pragmatic and relevant methodology. The explicit opportunity to pro-actively agree on that approach with FINMA is also likely to act as an accelerator compared to the EU process.

3. Differences to Solvency II ORSA

The Swiss ORSA requirements aim to bring Swiss regulations in line with EU Solvency II requirements, but there are however some important differences.

- FINMA has not provided a detailed manual of how to implement Swiss ORSA. Insurers are therefore able to exercise a fair degree of discretion which will allow them to adapt existing systems rather than having to follow tight autocratic requirements. This contrasts with Solvency II's more normative nature.
- FINMA states that the Board of Directors of the insurer is responsible for ensuring that ORSA is implemented and used. ORSA should be an integral part of business strategy and business planning. FINMA states that the Board of Directors and senior management should use the results of ORSA in their decision-making processes, but in comparison to Solvency II, where it is stated that the Board should take an active part in the ORSA, including steering, how the assessment is to be performed and challenging the results, FINMA is less onerous in Board involvement.
- Swiss insurers will have to document the ORSA principles and the design of the ORSA processes in an "ORSA Policy" in line with Solvency II although more ambiguous. Solvency II requirements describe expectations regarding minimum information that should be included in the policy.
- The timeframe Swiss insurers must consider for their ORSA is explicitly stated as the current business year and at least two more years. In Solvency II it is stated that an insurer needs to project its capital needs at least over its business planning period. In practice we have seen the EU regulators require more but that period has not been defined explicitly and we see differences from one EU country to another.
- FINMA is also more onerous than Solvency II on the way risk should be categorized and on the assessment of risk concentrations and dependencies. Both sets of requirements endeavour to make companies define their total risk profile regardless of whether these risks can be assessed quantitatively or qualitatively, but Swiss ORSA highlights a group's holding structure and hence the issue of capital fungibility.

- Not only the pertinent aspects of regulatory capital requirements should be considered, by Swiss insurers, but also the views from the management on the capital for financial control. Considering all possible scenarios in every planning year with every pertinent aspect, the available capital against capital requirements should be defined and estimated. This is in line with Solvency II. FINMA is unclear when it comes to the obligation for insurers to estimate their "continuous alignment" with regulatory capital and technical provision requirements over the planning time frame.

- The Swiss ORSA reporting requirements differ slightly from Solvency II. Swiss insurers of the supervisory categories 2 and 3 will have to file with FINMA at least annually a report on the outcome of the ORSA, but Swiss insurers of the supervisory categories 4 and 5 and reinsurance captives are exempt from ORSA reporting requirements until further notice, although they will be required to perform an ORSA.

- In line with Solvency II, FINMA considers the size and complexity of the insurers and takes into account the principle of proportionality, however FINMA permits reinsurance captives to perform a less complicated ORSA.