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Research Report

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SAFE Policy Letter, No. 11

Provided in Cooperation with:

Leibniz Institute for Financial Research SAFE

Suggested Citation: Gründl, Helmut; Gal, Jens (2013) : Own Risk and Solvency Assessment within the Solvency II Framework and its interplay with the quantitative solvency capital requirements, SAFE Policy Letter, No. 11, Goethe University Frankfurt, SAFE - Sustainable Architecture for Finance in Europe, Frankfurt a. M., <https://nbn-resolving.de/urn:nbn:de:hebis:30:3-294790>

This Version is available at:

<https://hdl.handle.net/10419/106961>

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Own Risk and Solvency Assessment Within the Solvency II Framework and its Interplay with the Quantitative Solvency Capital Requirements

Policy Letter Series No. 11

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Own Risk and Solvency Assessment (ORSA) Within the Solvency II Framework and its Interplay with the Quantitative Solvency Capital Requirements

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1. Introduction

Pursuant to art. 45 of the Solvency II Framework Directive (2009/138/EC of the European Parliament and the Council of 25 Nov. 2009 on Solvency II [OJ L 335/1 of 17.12.2009]), all insurance undertakings will be obliged to conduct an “Own Risk and Solvency Assessment” (ORSA). As can be derived from its legislative position within the framework directive, ORSA represents an integral part of the undertakings’ risk management system.

One would, however, be mistaken to assume that ORSA’s relevance is limited to the second pillar of Solvency II, where mainly qualitative requirements are to be found. ORSA rather exhibits strong interlinks with the first pillar and its quantitative requirements. However, ORSA may also serve as a trigger for transparency duties which form Solvency II’s third pillar. ORSA will hereby equally become a basis for the supervisory review process (SRP) in the course of which national supervisory authorities might implement supervisory measures with regard to any one of the three pillars. ORSA may thus be described in some respects as the glue that binds all three pillars of Solvency II together. Despite this fact, ORSA has hitherto remained surprisingly ill-defined. The interplay between the calculation of the solvency capital requirements in Pillar I and ORSA in particular have not yet been conclusively clarified.

2. Properties of ORSA

Since the draft of the Regulatory Technical Standards, which are to be passed in the form of a regulation on the second Lamfalussy level, does not provide for any detailed regulation of the ORSA, any assessment of the latter must for the moment begin and, unfortunately, end with the definition given by the Solvency II Directive. According to art. 45 of said directive, ORSA should describe the “overall solvency needs” of an insurer, its continuous compliance with the capital requirements of Pillar I and an assessment of the significance of different assumptions made for Pillar I calculations and for the ORSA. Furthermore, ORSA’s goal is also a long-term assessment of an insurer’s solvency situation. In addition, ORSA is to be an integral part of the insurer’s business strategy and its strategic decision-making. This, however, should not be misunderstood: ORSA “shall not serve to calculate a capital requirement” (art. 45 [7]). ORSA rather consists of a qualitative and a quantitative component, the latter’s purpose being not the calculation of a capital requirements distinct from those of Pillar I, but rather twofold: on the one hand, ORSA’s task consists of evaluating whether the standard formula is sufficient to address adequately all risks to which the undertaking is exposed. The undertaking has to

determine its own specific risk profile and has to evaluate whether this risk profile deviates significantly (!) from the assumptions underlying the standard formula. On the other hand, and this shall be the main focus here, ORSA is to project these capital requirements into another time frame and to reevaluate them under the overall risk exposure with a medium and long-term horizon.

This being said, ORSA goes beyond Pillar I in two ways:

1. Besides the actual risk and solvency assessment, in its ORSA, an insurer has to demonstrate satisfactorily the presence of adequate processes that identify and assess its risks properly.
2. In contrast to Pillar I's one-year time horizon, ORSA has an explicit long-term horizon of the solvency assessment.

As for the second point, the calculations of the solvency capital requirements and the determination of an insurer's own funds under Pillar I form the natural starting point of every undertaking's ORSA. However, one must differentiate in terms of whether the insurer applies the standard formula under Pillar I, a partial internal model or a full internal model for these calculations.

3. Long-Term Risk and Solvency Assessment

If we assume that a full internal model is adequately able to map the risk and solvency situation of an insurer, it should be a straightforward exercise to extend such a full internal model to a long-term time horizon. Problems of extending the Pillar I calculations into a multi-year context arise first and foremost for those insurers that apply partial internal models or the standard formula.

The modular structure of the standard formula builds an obstacle to its multi-year extension. It is particularly unclear how the capital requirements in the different risk modules and their submodules would have to be adjusted to lead to a desired multi-year solvency level. Incidentally, this issue also applies to internal models that have a modular approach like the standard formula.

Users of the standard formula, who probably prefer it to an internal model for cost reasons, therefore fear that they might be forced to install a full internal model due to the ORSA regulations. This is certainly not the intention of the Solvency II Directive (cp. recital 36). The Directive, nevertheless, does not offer any guidance as to how small and medium-sized undertakings are to achieve their ORSA without developing an internal model and still have the ORSA address their specific overall solvency needs. One could come to the conclusion that the users of the standard formula are required to square the circle when undertaking their own risk and solvency assessment.

In reality, the situation is not necessarily as dire as that and the solution we put forward can be outlined as follows: the standard formula is based on the risk situation of a representative insurance company (subsequently referred to as the "standard insurer"). Its explicit characteristics, such as the structure of its life or non-life underwriting portfolio and the composition of its different asset classes, should be published by EIOPA and should then serve as the relevant benchmark. This implies a translation of the assumptions on the underlying probability distributions into directly observable characteristics. In line with art. 45

1(c) of the Directive, an insurer could then assess in which areas and to what extent its individual characteristics deviate from those of the standard insurer. The underwriting portfolio or the equity portfolio might, for example, exhibit a higher or a lower risk level compared to those of the standard insurer. This comparison would enable a standard formula user to assess in a first step its own risk and solvency situation. The insurer can describe the deviations from the standard insurer both qualitatively and quantitatively. Based on this assessment, the insurer can outline through which measures it intends to mitigate those risks that exceed those of the standard insurer: greater own funds, more reinsurance coverage etc. The chosen measures may differ depending on the underlying time horizon.

The supervisory authorities, in turn, also referring to the deviations from the standard insurer, can then assess to what extent the proposed measures and processes are adequate or whether a capital add-on according to art. 37 of the Directive might be necessary. One should keep in mind, however, that ORSA is not intended to calculate a capital requirement. Therefore, the exposition of inadequately addressed risks by ORSA cannot automatically result in the setting of a capital add-on. It can be expected that EIOPA, over the years, will formulate best practice guidelines to estimate the adequateness of chosen risk management measures.

The proposed comparison with the standard insurer as the core of ORSA for standard formula users is, of course, a relatively crude procedure. However, “crudeness” also applies to the way the standard formula determines the solvency capital requirement. Our proposal therefore keeps up the intended degree of sophistication by transferring it from Pillar I to the ORSA. If the users of the standard formula were not given such a benchmark for comparison, the undertakings would, against the legislative will of the drafters of the directive, have to continuously assess whether their overall solvency needs can be adequately calculated by the standard formula. It is difficult to see how such an assessment would then not indirectly require the establishment of some form of internal model. The establishment of the “standard insurer” thus seems to be an almost indispensable tool.

4. Implications for the present “preparatory phase”

In light of the retardation of the implementation of the Solvency II Project, EIOPA has decided to propose the adaptation of several guidelines in order to prepare the insurers for the future application of Solvency II. One such set of guidelines also addresses the forward-looking assessment of the undertakings’ own risks (EIOPA, BoS-13/25 and EIOPA-CP-13/009). The guidelines – that are to be imposed by the national supervisors beginning in 2014 – thus aim to prepare the undertakings for their future duties to conduct an ORSA.

The question thus arises of whether the creation of a “standard insurer”, as outlined above, would already be necessary in this preparatory phase. At first glance, one tends to answer in the negative, since the guidelines focus particularly on the implementation of processes and procedures and not on the overall solvency needs in terms of numbers. The consultation paper for the guidelines thus sets out that the guidelines focus “on what is to be achieved by this assessment rather than on how it is to be performed” (para. 1.12). This is not at all surprising, since the ORSA exhibits a strong interconnection with the quantitative requirements of Pillar I, which are not yet in force.

The legal situation will, however, not be as simple as that. In the following section, the guidelines declare that insurers must also assess their overall solvency needs quantitatively (cp. guidelines n^{os} 11 et seqq.) and that these quantitative assessments will require insurers to

perform their duties under the working hypothesis that the Solvency II capital requirements are already binding. This would put users of the standard formula (i.e. all insurers that do not opt for the pre-application for Internal Models [see EIOPA-CP-13/011]) under considerable strain. This problem is to some degree mitigated by guideline n° 3 which sets a threshold that only such insurers that fall within the category of those insurers that collectively represent at least 80 % of the market share are to be legally required to base their quantitative assessment on the assumption that the Solvency II quantitative requirements of Pillar I already apply [concerning the calculation of the market share, the guidelines refer to the guidelines n° 5 et seqq. of the *transparency* guidelines (EIOPA-CP-13/010)]. This helps, however, only such small and medium-sized insurers that make up the remaining 20 % of the market share. They would need – though this may be arguable – to base their risk evaluation not on the capital requirements of Solvency II, but rather on the national capital requirements (based on Solvency I) in force in their home country.

This leaves, however, all users of the standard formula that belong to the 80 % category exposed to the same problem regarding ORSA that will arise once Solvency II is finally implemented. For them, the situation during the preparatory phase will be rather precarious. Insurers will have to meet the existing capital requirements of their home country and will, where applicable, have to fulfil the forward-looking assessment based on these capital requirements. They will now also be required to make an additional forward-looking assessment based on the hypothesis that the Solvency II capital requirements already apply. Given this situation, it would seem questionable to require users of the standard formula – they are, to be more precise, hypothetical users of the standard formula – to establish *quasi* internal models in order to assess how and why their risk profile differs from the assumptions underlying the standard formula. Again, a straight-forward and workable solution would be for EIOPA to establish a standard insurer which would serve as a point of reference for users of the standard formula when fulfilling their duty under guideline n° 16, which requires companies to assess the deviation of their risk profile from the underlying assumptions of the standard formula.

Whilst this would certainly put EIOPA under considerable time pressure, the creation of the standard insurer within the preparatory phase would have two advantages. Firstly, it would alleviate the pressure on users of the standard formula in this especially burdensome period. Secondly, EIOPA would be able to refine the characteristics of the standard insurer and test them against reality in order to establish a finely tuned frame of reference once the Solvency II regime becomes binding on the insurers.

5. Conclusion

Since the adaptation of the Solvency II Directive, ORSA has, to some extent, remained its most enigmatic component. This was caused by the fact that ORSA is one of the most obvious examples of the supervisory shift from a rules-based to a principles-based approach. As such, ORSA has hitherto been only very roughly defined. Whilst the move towards a more principles-based supervision was generally met with strong support, the same was not true for the rather ill-defined nature of ORSA. It is possible that the general human fear of the uncertain has turned ORSA into something of a bogeyman for small and medium-sized undertakings. They dread that ORSA will require them through the back door, despite their application of the standard formula on Pillar I, to establish an internal model in order to assess whether their overall solvency needs are adequately addressed by the standard formula. This fear is not completely without basis. In the present contribution, however, we have attempted

to point out a way to cut through the red tape. Since it is for the undertaking to determine its own specific risk profile and to evaluate whether this risk profile deviates significantly from the assumptions underlying the standard formula, it seems only natural that the supervisor must specify in greater detail what these underlying assumptions are. The most practicable way to do so would be for EIOPA to establish a “standard insurer”, which implies a translation of the assumptions concerning the underlying probability distributions into directly observable characteristics. Whether the establishment of such a legal fiction can be achieved before EIOPA’s preparatory guidelines are enacted seems doubtful. If EIOPA is correct in its assessment that these guidelines will for the most part focus on processes rather than on sheer numbers, the creation of the standard insurer might not seem the most pressing item on the agenda. However, it would be an important step towards relaxing the insurers’ fear of what ORSA might bring about.