Learning lessons from Solvency II

There are lessons to learn for insurers in implementing Solvency II, as the European Insurance and Occupational Pensions Authority (EIOPA) discovered when it undertook the first analysis of progress since the regulations started

BY GABRIEL BERNARDINO

The application of Solvency II to insurers from January 1, 2016, signalled a shift in the assessment of solvency, moving to a preventive and risk-based approach. While Solvency II introduced new requirements relating to capital management and disclosure, it also established governance and risk management as a central pillar of the framework.

Historically, studies of insurance failures have shown that the primary causes of failure have been as much about poor management and inappropriate risk decisions as they have been about inadequate capitalisation. This demonstrates that in risk management, *management* is just as important as *risk* and makes the risk management function one of the most important functions in insurance governance systems.

Solvency II requires all insurance and reinsurance companies to have an effective system of governance – including risk management – in place, which is proportional to the nature, scale and complexity of the business.

> **Board members should possess risk management skills and sound risk management procedures**

> The risk management function is one of the most important functions in insurance governance systems

Risk and the board

An effective risk management function is one that assists the board and other functions in the operation of the risk management system, monitors the risk management system and the risk profile, reports on risk exposures and advises the board, and identifies and assesses emerging risks.

With Solvency II, companies are expected to adopt the necessary changes in their organisational structure, so that the risk management function can effectively comply with its tasks, with operational independence and with direct access to the board. In particular, the risk management function needs to be sufficiently resourced and staffed by professionals with the right level of risk management skills. Similarly, board members should possess risk management skills and sound risk management procedures, integrated into a comprehensive framework with proper documentation in place.

ORSA – making sense of risk

In addition to the greater focus on the overall risk management function and the capacity of board members to integrate risk into their strategic decisions, Solvency II also calls for a more forward-looking approach to risk management. This means that insurance companies must also consider any future developments that might have an impact on their business, such as business expansion plans. The *Own risk and solvency assessment* (ORSA) is a powerful risk management tool that sets out the principles of forward-looking self-assessment of risk management and solvency for insurers.

ORSA encourages a more holistic view of risk, both quantitative and qualitative, and favours a more in-depth look at the whole business, rather than focusing solely on financial risk.

While ORSA acts as an internal assessment process within the undertaking and is therefore embedded in the organisation's strategic decision-making process, it also acts as a supervisory tool for national supervisory authorities, since insurers must keep supervisory authorities informed of the results of ORSAs.

EIOPA's role

One of the most important strategic objectives of EIOPA is to achieve consistent supervisory practices, and EIOPA monitors the implementation of Solvency II with particular attention to the governance system, including risk management.

To foster a higher level of conduct of supervision, EIOPA has developed a supervisory handbook of good supervisory practices related to Solvency II, with chapters covering the roles and responsibilities of board

> EIOPA expects board members to use the ORSA results in their strategic decision-making process to enhance the overall risk management of undertakings

members and key functions, as well as ORSA governance.

EIOPA has also conducted an analysis on the implementation of ORSA based on the supervisory assessments conducted by national supervisory authorities. This analysis provides a first insight into national experiences with the supervisory assessment of ORSA and points to areas for further improvement.

State of play

EIOPA's analysis shows that while insurance and reinsurance companies are making good progress in implementation, there is scope for further improvements.

Most undertakings have made good progress in implementing ORSA processes and policy. In particular, during the last few years, the vast majority of insurers have established well-functioning internal processes that allow the right people to be involved in and take responsibility for the conduct of ORSA.

EIOPA has seen, however, that small insurance businesses tend to face more challenges in implementing and applying ORSA processes. This encourages them to further elaborate on ORSA processes including their ORSA policy and the quality of data used in assessments.

Room for improvement

In its analysis of ORSA implementation, EIOPA has observed a number of areas for improvement, notably the need for a greater involvement of the administrative, management or supervisory bodies. In this regard, EIOPA encourages insurers to improve the involvement of their administrative, management or supervisory bodies in the ORSA process. Board members are expected to follow the top-down approach and to play an active role in the ORSA assessment. EIOPA expects board members to use the ORSA results in their strategic decision-making process to enhance the overall risk management of undertakings.

There is also scope to further expand risk assessment. According to ORSA requirements, undertakings should assess all current or potential material risks, including those that are not quantifiable. The findings show that risk assessments do not always include all potential risks and, in many cases, the assessments are not linked to the business model and strategic management actions of the undertaking. Therefore, EIOPA calls upon insurers to widen the scope of their risk assessment and to deepen the risk analysis.

EIOPA's analysis indicates that there is an overreliance on the standard formula by undertakings. In addition, the assessment of the significance of the degree to which risk profiles deviate from the assumptions underlying the solvency capital requirement under the standard formula should be further improved. EIOPA expects all organisations to perform an assessment of their specific risk

> **Effective governance, like risk management, is not a tick-box exercise; instead good governance is one of the best tools to enable sound business practices**

profile when calculating their overall solvency needs, taking into account the proportionality principle.

Finally, there is scope to improve the quality of stress testing including reverse stress tests and scenarios used in the ORSA assessments. The stress criteria used should enable insurers to evaluate appropriately in a forward-looking perspective the potential risks they and their business may be exposed to and the required solvency in order to manage such risks. EIOPA encourages undertakings to further improve the quality of stress testing.

While recognising the steps taken by insurance and reinsurance companies in implementing ORSA, further improvements will help to better embed this risk management tool into business strategy.

Good for business

Risk management and, in particular, ORSA are essential elements of good governance. An effective governance system encompasses more than risk management to provide for a holistic approach to sound and prudent management of business. Solvency II promotes sound and robust behaviour to manage and reduce risks through well-defined governance systems. EIOPA has identified a number of characteristics that contribute to an effective and proportionate governance system.

These include an adequate and transparent organisational structure with a clear allocation and appropriate segregation of responsibilities, with written policies in place – including in relation to risk management. In addition, there should be at least four established key functions that are independent from each other and with a clear segregation of responsibilities. There should be contingency plans in place for the appointment of board members and key function holders. Finally, if any key tasks or functions are outsourced, there should be no negative impact on either the governance system or operational risks.

Effective governance, like risk management, is not a tick-box exercise; instead good governance is one of the best tools to enable sound business practices.

Benefit for consumers

In many cases, developing and implementing an appropriate and effective governance system, including risk management, will require a cultural change, starting at the top. This cannot be achieved overnight, and the role of senior management and board members is central to its success. An organisation's board needs to set, communicate and enforce a risk culture that consistently influences, directs and aligns with the strategy and objectives of the business.

The right approach to risk management should also reflect well with the consumers. Solvency II aims to ensure a uniform and enhanced level of protection for policyholders across the European Union, and a more robust system should give policyholders greater confidence in insurers and their products.

To conclude, risk management is an essential function for business planning and strategic decision-making. Solvency II and, in particular, ORSA are powerful tools to help companies taking a holistic approach to risk which, in the longer term, can only serve to benefit consumers and policyholders.

Gabriel Bernardino, chairman of the European Insurance and Occupational Pensions Authority (EIOPA)

> **EIOPA calls upon insurers to widen the scope of their risk assessment and to deepen the risk analysis**