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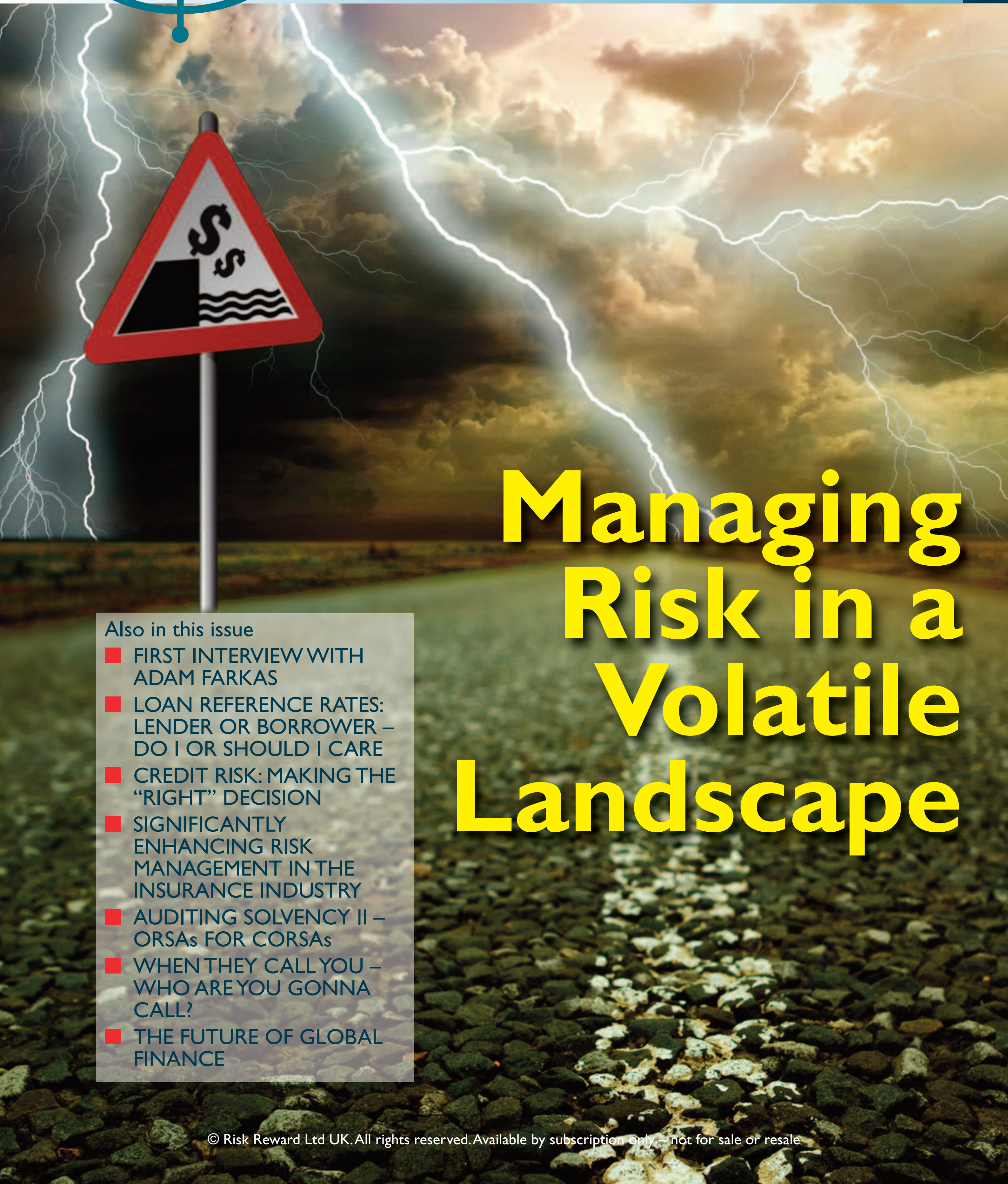

Managing Risk in a Volatile Landscape

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AUDITING SOLVENCY II: ORSAs FOR CORSAs

John Webb, FCCA, is the Director of Solvency II at Risk Reward Ltd. This is the second in a series of articles on the auditing of Solvency II projects for insurers and banks with insurance businesses.

As insurance and reinsurance companies wrestle with the continuously changing expectations and timetable slippages inherent in Solvency II, this is a major challenge for management. Consequently Internal Audit really has to address the growing expectations upon it for performing additional and specific audit testing. This may include some internal audit teams requiring enhanced skills and additional business knowledge.

It is still some time before Solvency II compliance will be required and all of the detailed requirements will be known with certainty, but there is so much for the industry to do in order to be prepared for that moment (or period of time, given that it will be phased in). Much thought needs to be given to the way in which Internal Audit should approach the Solvency II work being undertaken within its organisation. In this article I and am setting out our initial thoughts on what is a suggested approach to this exciting challenge.

Classifying High Level Controls

Solvency II is all about risk management and demonstrating that risk management is embedded; addressing the full range of risks faced by insurers, not just underwriting risks, in determining capital. The Own Risk and Solvency Assessment will be predominant and the acid test for all of this will be the 'use test'. To attain a Capital-controlling Own Risk and Solvency Assessment (CORSA) we must demonstrate the Own Risk and Solvency Assessment meets this use test, in all material regards. Their use will ensure it really is ORSAs for CORSAs!

A good place to start an audit testing programme will be to predefine the generic areas for classifying risks at a high level, then documenting control procedures and specifying the detailed audit tests envisaged at this early stage, for testing these controls. I would start with following high level list: -

1. Risk Management Governance
2. Actuarial and Internal Model Governance
3. Solvency II Project Governance
4. Demonstrating Adequate Financial Resources (Pillar 1)
5. Internal Model
6. Risk Management Systems and the Use Test
7. Own Risk and Solvency Assessment (Pillar 2)
8. Reporting Requirements (Pillar 3)
9. Compliance Monitoring Approach

Risk Management Governance

Taking each of these in turn and thus starting with, Risk Management Governance, this section of the programme will include tests to ensure that: -

- The board is fully involved; including setting objectives, risk management strategy, risk appetite, Solvency II strategy and that there is a training programme.
- There is an Internal Audit function capable of delivering an internal audit service, irrespective of the extent to which it may be out sourced.
- The relationship with the regulators, currently the Financial Services Authority but later to be the Prudential Regulatory Authority, will be controlled and able to demonstrate embedded risk management and strong ORSA, economic capital modelling and internal model application processes.
- A gap analysis to show Solvency II requirements which are not being met by the present ICAS regime compliance processes for each insurer.

Actuarial and Internal Model Governance

Turning to Actuarial and Internal Model Governance, tests are required to determine whether: -

- There is a strong Actuarial function and it is properly involved (in a well documented manner) with internal model construction and calibration, validation, scenario and stress testing and model output and technical provision integrity.
- Governance of the internal model which includes, board approval, management assessment of economic capital and the Solvency Capital Requirement. This in turn should be supported by expertise in risk and capital management, as well as compliance, finance and actuarial knowledge.
- Outsourcing must be properly controlled and fully documented and approved.
- Insurance liabilities need to be calculated in a manner which ensures they are market consistent and appropriate.

Solvency II Project Governance

Solvency II Project Governance covers the safe delivery of the entire transformation project, which embeds risk management and builds it into the capital adequacy calculations. This will cover the range of change management controls, as well as ensuring that the Solvency II project will ensure that business written and its capital requirements, post implementation, will be properly controlled, documented and reported.

Demonstrating Adequate Financial Resources (Pillar 1)

In order to demonstrate Adequate

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Financial Resources, additional in depth tests will be required, to include those over the: -

- Various approaches to modelling which will calculate the Solvency Capital Requirement and the results of the standard formula, bearing in mind this may range from a fully stochastic capital model to a scenario based approach.
- Proper tiering of capital resources and elements.
- Approval to use internal models to calculate the regulatory capital requirements, itself sourced from an approved internal model and properly controlled data flows.
- Properly documented internal modelling, sufficient to justify such things as correlations assumed, aggregation, diversification benefits and the benefits of reinsurance and hedging.
- That assets are properly valued and market consistent.
- That non insurance liabilities are correctly calculated.
- That insurance liabilities are checked, market consistent in their valuation and that best estimates used in the technical provisions are properly supported and documented.
- That capital resources meet the capital requirements, both for basic and ancillary own funds, under Tier 1, 2 and 3 Capital. Such tiers reflect the degree of loss absorbency in the event of a winding up.
- Minimum Capital Requirements are met at a confidence level of 80-90%, over a one year period.
- Solvency Capital Requirements are met at a confidence level of 99.5%, over a one year period and that monitoring and breach reporting procedures are adequate. Also that contingency plans for remediation are put in place, ahead of time, to an extent that is considered reasonable.

Internal Model

With regard to the Internal model, tests are needed to cover: -

- Statistical quality standards including quality controls approved by the Chief Actuary and Risk Management. Also that strong monitoring processes over data exist.
- Assessment of the data, underlying assumptions and statistical quality for the internal model. This will include data integrity, testing and data monitoring.
- Calibration standards for the internal model, which must be properly documented. The insurance company needs to demonstrate that policy holders and beneficiaries will be given adequate protection.
- Profit and loss attribution needs to be tested to see that the sources of profit and/or loss for major business units can be explained by reference to the internal model risk categorisation and that the actual profit or loss is to be back tested and compared to predictions, so as to explain profit variations.
- That Internal model documentation is sufficient and thorough and that version control is assured.
- Internal model validation is sound. Confirmation standards are required, so that the internal model is demonstrably used for meeting the requirements of the use test, which in turn is bolstered by proper risk and capital management and the identification of emerging risks.

Risk Management Systems and the Use Test

Risk management systems need to be subject to audit testing to include: -

- That formal governance requirements have been developed and embedded. Crucially this must feed right through to the ORSA, under Pillar 2 and the report to supervisors and to the public, via the Solvency and Financial Conditions Report.
- The key components of the Use Test can be demonstrated including use of the internal model for key decisions across business units.
- In demonstrating that the use test is embedded, the internal model should be used for decisions to do with reinsurance, underwriting, product development, strategy and

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planning, for example.

- Any third party models and data are tested.
- That senior management review risk management processes regularly.

Own Risk and Solvency Assessment (Pillar 2)

Now on to the Own Risk and Solvency Assessment, audit testing should also cover: -

- Risk assessment processes and their documentation.
- The assessment of the ORSA process and that it is proportionate to the needs of management.
- That ORSA output is properly disseminated and actioned.

Reporting Requirements (Pillar 3)

Addressing reporting requirements, internal audit need to test that annual solvency reporting is complete and accurate. Also that sensitive information to be privately reported to the Prudential Regulatory Authority is done so securely and that compliance monitoring will be thorough.

Conclusion

In conclusion, internal audit, alongside the other assurance providers has a significant amount of work to do to ensure that the insurance company is in good shape to be able to deliver a phased implementation of Solvency II, commencing 1st January 2013. The auditable entity list for the firm is likely to be extended to address these important issues. Then internal audit also faces two very clear additional challenges. One is to add to the extensive list above, those additional matters which will be important to each specific company and the second is to reflect future changes to the Solvency II implementation guidance and rules.

There is clearly a knowledge issue that needs to be resolved. That will involve training the business in Solvency 2 issues and also for internal audit to work using the risk based approach to design tests that meet these challenging obligations. The expectation on internal audit are clearly increasing – and worse still the regulators will often be reviewing the control environment directly subsequent to the review conducted by the internal auditors – clearly increasing internal audit risk!

There is much to do and little time to do it – so the firms that start earliest will have the greatest ability to obtain the resources that they need to ensure that the project is successful from both a business and internal audit perspective.

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