MFSA

MALTA FINANCIAL SERVICES AUTHORITY

The System of Governance under Solvency II

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1. Introduction

Following the first guidance paper on Internal Models[1], the Malta Financial Services Authority (MFSA) is issuing a second guidance paper on the System of Governance with the aim of further highlighting and explaining key elements of the Solvency II regime, in order to continue to assist insurance undertakings in their preparations for the Solvency II implementation.

The Solvency II framework is based on three main pillars; Pillar 1 requires undertakings to demonstrate adequate financial resources; Pillar 2 requires the insurance undertakings to demonstrate an adequate system of governance; while the public disclosure and regulatory reporting requirements are covered by Pillar 3. This guidance paper focuses on the requirements of Pillar 2, providing guidance to having an effective risk management system as well as to a prospective risk identification process through the Own Risk and Solvency Assessment (ORSA).

The guidance paper is structured into sections by reference to the relevant articles of the "Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast)"[2] (henceforth referred to as the "Solvency II Directive" or the "Level 1 text"). These sections cite the relevant Level 1 text and provide commentary on the application of the proposed Level 2 requirements (Implementing Measures), the latter being drawn primarily from the Consultation Paper on the System of Governance[3] issued by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

Even though the new Solvency II governance requirements will only apply when the new regime enters into force, it is important for insurance undertakings to start implementing systems, processes and procedures with respect to the system of governance, if they have not already started. Under Solvency II, supervisory authorities will assess the adequacy of the governance system implemented by insurance undertakings, taking into account the scale, nature and complexity of the risks, in order to ensure that all risks that the undertakings are exposed to are suitably dealt with and that all the general requirements in respect of the governance system within the Solvency II Directive are being met.

Annexed to this paper is a questionnaire which seeks to determine which systems, processes and procedures insurance undertakings have already implemented, or plan to implement, in preparation for Solvency II with respect to the system of governance. Undertakings are required to respond to the questionnaire by **30 June 2010**. It is being requested that answers to the questions are given as objectively as possible.

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[1] This guidance paper, entitled "The Use and Approval of Internal Models for Regulatory Capital Purposes in Insurance", was issued on 3 December 2009.

[2] The link to the Solvency II Directive is available on the MFSA website www.mfsa.com.mt under Insurance - Solvency II - Solvency II Directive

[3] CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: System of Governance (former Consultation Paper No. 33) October 2009, available at http://www.ceiops.eu.

2. General governance requirements - Article 41

Article 41 of the Level 1 text states:

1. Member States shall require all insurance and reinsurance undertakings to have in place an effective system of governance which provides for sound and prudent management of the business.

That system shall at least include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information. It shall include compliance with the requirements laid down in Articles 42 to 49.

The system of governance shall be subject to regular internal review.

2. The system of governance shall be proportionate to the nature, scale and complexity of the operations of the insurance or reinsurance undertaking.

3. Insurance and reinsurance undertakings shall have written policies in relation to at least risk management, internal control, internal audit and, where relevant, outsourcing. They shall ensure that those policies are implemented.

Those written policies shall be reviewed at least annually. They shall be subject to prior approval by the administrative, management or supervisory body and be adapted in view of any significant change in the system or area concerned.

4. Insurance and reinsurance undertakings shall take reasonable steps to ensure continuity and regularity in the performance of their activities, including the development of contingency plans. To that end, the undertaking shall employ appropriate and proportionate systems, resources and procedures.

5. The supervisory authorities shall have appropriate means, methods and powers for verifying the system of governance of the insurance and reinsurance undertakings and for evaluating emerging risks identified by those undertakings which may affect their financial soundness.

The Member States shall ensure that the supervisory authorities have the powers necessary to require that the system of governance be improved and strengthened to ensure compliance with the requirements set out in Articles 42 to 49.

One of the biggest impacts from Solvency II on insurance companies is the expectation for senior executives to demonstrate in-depth understanding of the framework, improved management of their capital and better decision-making as a result of their identification of key organisational risks. These requirements build a strong case for the implementation of a robust **system of governance,** with a clear and well-defined organisational structure that has clear, consistent and documented lines of responsibility across the organisation. A good system of governance is about establishing, implementing and maintaining effective cooperation, internal reporting and communication of information at all relevant levels within the undertaking as well as establishing decision-making procedures. Undertakings

should ensure that the members of the administrative, management or supervisory body[4] possess sufficient professional qualifications, knowledge and experience in the relevant areas of the business to give adequate assurance that they are collectively able to provide a sound and prudent management of the undertaking, as required by Article 41(1).

Undertakings are required to establish and maintain adequate risk management, compliance, internal audit and actuarial functions, the characteristics of which are detailed and discussed below. The undertaking's system of governance should ensure it employs personnel with the skills, knowledge and expertise necessary to discharge properly the responsibilities allocated to them, and that such personnel are aware of the procedures for the proper discharge of their responsibilities. Any performance of multiple tasks by individuals should not prevent the persons concerned from discharging any particular function soundly, honestly and professionally.

Undertakings should ensure that they have sound information systems in place that produce sufficient, reliable, consistent, timely and relevant information concerning all business activities, the commitments assumed and the risks to which the undertaking is exposed. Whilst the nature of the information in question should be taken into account to safeguard its security, integrity and confidentiality, undertakings may need to introduce clear reporting lines that ensure the prompt transfer of information to all persons who need it in a way that enables them to recognise its importance. Clearly, undertakings should maintain adequate and orderly records of their business and internal organizations to achieve this.

The proportionality requirement under Article 41(2) applies to every element of the system of governance. It is the responsibility of the administrative, management or supervisory body to ensure that the undertaking's organisational structure delivers a system of governance proportionate to the nature, scale and complexity of the risks it faces in its business activities.

3. Fit and proper requirements - Article 42

Article 42 of the Level 1 text states:

1. Insurance and reinsurance undertakings shall ensure that all persons who effectively run the undertaking or have other key functions at all times fulfil the following requirements:

(a) their professional qualifications, knowledge and experience are adequate to enable sound and prudent management (fit); and

(b) they are of good repute and integrity (proper).

[4] Whilst throughout this paper we have used the term "administrative, management or supervisory body" as it is used in the Solvency II Directive, this refers to the board of directors.

2. Insurance and reinsurance undertakings shall notify the supervisory authority of any changes to the identity of the persons who effectively run the undertaking or are responsible for other key functions, along with all information needed to assess whether any new persons appointed to manage the undertaking are fit and proper.

3. Insurance and reinsurance undertakings shall notify their supervisory authority if any of the persons referred to in paragraphs 1 and 2 have been replaced because they no longer fulfil the requirements referred to in paragraph 1.

The fit and proper requirements under Article 42(1) apply to all persons who effectively run the undertaking or have other key functions. These are not limited to the members of the administrative, management or supervisory body of the undertaking, but could include other persons such as senior managers. Such senior managers could be persons employed by the undertaking who are responsible for high level decision making and implementing the strategies devised and the politics approved by the administrative, management or supervisory body. The other “key functions” are those considered critical or important in the system of governance and include at least the risk management, the compliance, the internal audit and the actuarial functions. Other functions may be considered key functions according to the nature, scale and complexity of an undertaking’s business or the way it is organised.

Undertakings will need to establish who the persons that effectively run the undertaking are and notify the supervisory authority accordingly. When assessing the fitness and propriety of a person the supervisory authority must include an assessment of his/her professional competence both in terms of management (management competence) as well as in the area of the business activities carried out by the undertaking (technical competence). Should the authority conclude, with adequate justification, that the person to be appointed (or already appointed) does not comply with the relevant fit and proper requirements, the authority has the power to require the undertaking not to appoint (or to replace) the person in question.

When deciding on the persons falling under the provisions of Article 42, the nature, scale and complexity of the risks inherent in the business of the undertaking should be taken into account, as well as the function itself and the way the undertaking is organised. However the proportionality principle does not result in different standards in the case of the fit and proper requirements, since the repute and integrity of the persons running the undertaking or holding key functions should always be on the same adequate level irrespective of the nature, scale and complexity of the business or of the undertaking’s risk profile.

4. Risk management - Article 44

Article 44 of the Level 1 text states:

1. Insurance and reinsurance undertakings shall have in place an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risks, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies.

That risk-management system shall be effective and well integrated into the organisational structure and in the decision-making processes of the insurance or reinsurance undertaking with proper consideration of the persons who effectively run the undertaking or have other key functions.

2. The risk-management system shall cover the risks to be included in the calculation of the Solvency Capital Requirement as set out in Article 101(4) as well as the risks which are not or not fully included in the calculation thereof. The risk-management system shall cover at least the following areas:

(a) underwriting and reserving;
(b) asset–liability management;
(c) investment, in particular derivatives and similar commitments;
(d) liquidity and concentration risk management;
(e) operational risk management;
(f) reinsurance and other risk-mitigation techniques.

The written policy on risk management referred to in Article 41(3) shall comprise policies relating to points (a) to (f) of the second subparagraph of this paragraph.

3. As regards investment risk, insurance and reinsurance undertakings shall demonstrate that they comply with Chapter VI, Section 6.

4. Insurance and reinsurance undertakings shall provide for a risk-management function which shall be structured in such a way as to facilitate the implementation of the risk-management system.

5. For insurance and reinsurance undertakings using a partial or full internal model approved in accordance with Articles 112 and 113 the risk-management function shall cover the following additional tasks:

(a) to design and implement the internal model;
(b) to test and validate the internal model;
(c) to document the internal model and any subsequent changes made to it;
(d) to analyse the performance of the internal model and to produce summary reports thereof;
(e) to inform the administrative, management or supervisory body about the performance of the internal model, suggesting areas needing improvement, and up-dating that body on the status of efforts to improve previously identified weaknesses.

Effective risk management and enterprise-wide governance are cornerstones of a sound solvency system. While it is necessary for insurers to hold adequate capital, the decisions of senior management and the quality of group controls may potentially be even more crucial for an insurer's long-term health.

Article 44 requires undertakings to have an effective risk management system. Specifically, it requires undertakings to establish, implement and maintain:

- A clearly defined and well documented risk management strategy that includes the risk management objectives, key risk management principles, general risk appetite and assignment of responsibilities across all the activities of the undertaking and is consistent with the undertaking's overall business strategy;
- Adequate written policies that include a definition and categorisation of the material risks faced by the undertaking. Categorisation should be carried out by risk type and by the levels of acceptable risk limits for each risk type;
- Appropriate processes and procedures which enable the undertaking to identify, assess, manage, monitor and report the risks it is or might be exposed to;
- Appropriate reporting procedures and feedback loops that ensure that information on the risk management system, which is coordinated and challenged by the risk management function is actively monitored and managed by all relevant staff and the administrative, management or supervisory body;
- Reports that are submitted to the administrative, management or supervisory body by the risk management function on the material risks faced by the undertaking and on the effectiveness of the risk management system; and
- An appropriate ORSA process (see section 5).

The undertaking needs to establish a risk management function within its organisational structure that is proportionate to the scale, nature and complexity of risks inherent within the business. The risk management function should be kept objective and free from influence from other functions and from the administrative, management or supervisory body.

The risk management function is responsible for the coordination across the undertaking of risk management activities. The tasks of the risk management function include:

- Assisting the administrative, management or supervisory body and other management in the effective operation of the risk management system, in particular by performing specialist analysis and performing quality reviews;
- Monitoring the risk management system;
- Maintaining an organisation-wide and aggregated view on the risk profile of the undertaking;
- Reporting details on risk exposures and advising the administrative, management or supervisory body with regard to risk management matters in relation to strategic affairs such as corporate strategy, mergers and acquisitions and major projects and investments; and
- Identifying and assessing emerging risks.

If the undertaking uses an internal model, then this model is part of a comprehensive risk management system that should have adequate resources and structures to ensure that the internal model is and stays appropriate to the undertaking's risk profile.

In this context, the risk management function shall be responsible for the way in which the internal model is designed and integrated with the undertaking's internal risk management system and the day-to-day functions of the undertaking. It shall assess the internal model as a tool of risk management and as a tool to calculate the undertaking's SCR. As part of this process, the risk management function should regularly test and validate the internal model with a view to identify weaknesses, to improve the model and to ensure that the model remains appropriate to the risk profile of the undertaking. Documentation of the internal model, and any subsequent changes to it, should be owned by the risk management function so that these are explained in the context of the risk management system.

4.1 Areas to be covered by the risk management system

Article 44(2) specifically identifies risk areas to be included in the risk management system. These are:

(a) Underwriting and reserving

Underwriting risk refers to the risk of loss, or of adverse change in the value of insurance liabilities, due to inadequate pricing and reserving assumptions. Underwriting and reserving risk includes the fluctuations in the timing, frequency and severity of insured events, relative to the expectations of the undertaking at the time of underwriting. This risk can also refer to fluctuations in the timing and amount of claims settlements.

Undertakings should have in place suitable processes and procedures to ensure the reliability, sufficiency and adequacy of both the statistical and accounting data to be considered both in the underwriting and reserving processes. Undertakings should also have in place adequate claims management procedures which cover the overall cycle of claims: receipt, assessment, processing and settlement, complaints and dispute settlement and reinsurance recoverables.

(b) Asset–liability management

Asset-liability management (ALM) is the management of a business in such a way that decisions on assets and liabilities are coordinated in order to manage the exposure to the risk associated with the variation of their economic values. Along with the investment strategy, an ALM strategy should describe how financial and insurance risks will be managed in an asset-liability framework in the short, medium and long term. Where appropriate the investment strategy and the ALM strategy could be integrated in a combined investment/ALM-strategy.

The developed ALM policies should take into account the interrelation with different types of risks, such as market risks, credit risks, liquidity risks and underwriting risks, and establish ways to manage the possible effect of options embedded in the insurance products. Therefore such policies should provide for the structuring of the assets that ensures the undertaking holds sufficient cash and diversified marketable securities of an appropriate nature, term and liquidity to meet its obligations, including obligations to pay bonuses to policyholders, as they fall due. Undertakings should also include within the ALM policies a plan to deal with unexpected cash outflows as well as identifying mitigation

techniques and their impact on embedded options, and the assessment of the possible effects these can have throughout the life of the insurance policies and/or reinsurance contracts.

(c) Investment in particular derivatives and similar commitments

Investments are subject to market risk. Market risk is the risk of loss, or of adverse change in the financial situation, resulting directly or indirectly from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments.

Undertakings must thoroughly understand the products they want to invest in, and for complex products should preferably use risk management models that consider all relevant variables. When undertakings use derivative products or any other financial instrument with similar characteristics, such as asset-backed securities, collateralised debt obligations or hedge funds, the adopted investment policy shall take into account the goals and strategies of their use and the way they contribute to an efficient portfolio management, as well as procedures to evaluate the strategy to use these types of products and the principles of risk management to be applied.

(d) Liquidity and concentration risk management

Liquidity risk refers to the risk that undertakings are unable to realize investments and other assets in order to settle their financial obligations when they fall due. Liquidity in this context is the availability of funds, or certainty that funds will be available without significant losses, to honour all cash outflow commitments (both on and off-balance sheet) as they fall due. These commitments are generally met through cash inflows, supplemented by assets readily convertible to cash.

It is the undertaking's responsibility to have sound liquidity management practices which cover both short and long term considerations and include stress tests and scenario analyses. Liquidity considerations over a long term need to be assessed in a way which recognizes the possibility of various unexpected and potentially adverse business conditions where asset values may not be realised for current market values.

Concentration risk means all risk exposures (credit risk, market risk, underwriting risk, liquidity risk and other risks, as well as a combination or interaction of those risks) with a loss potential which is large enough to threaten the solvency or the financial position of undertakings. Such exposures can originate from a series of sources, including geographical areas, (entity or group) counterparties, economic sectors, types of products, providers of services, reinsurance and cumulative exposures in the insurance contracts (both explicit and embedded). In order to properly manage concentration risk, undertakings should define such sources of risk concentration relevant for their portfolios and establish adequate procedures and processes for the active monitoring and management of concentration risk to ensure that it stays within established policies and limits and mitigating actions can be taken as necessary.

(e) Operational risk management

Operational risk refers to the risk of loss arising from inadequate or failed internal processes, or from personnel and systems, or from external events.

The administrative, management or supervisory body should be aware of and consider the major categories and exposures of the undertaking's operational risks as a distinct risk category that should be managed, whereby this operational risk management framework is integrated into the risk management process of the undertaking.

Effective operational risk identification should consider the undertaking's business environment and internal control factors, including:

(i) Internal factors, such as the undertaking's structure, the nature of its activities, products and processes, the quality of its human resources, organisational changes and employee turnover; and

(ii) External factors, including changes in the industry, the legal environment and technological developments that could adversely affect the achievement of the undertaking's objectives and its operational risk profile.

The undertaking should implement an effective process to regularly identify, document and monitor exposure to operational risk and track relevant operational risk data, including near misses.

(f) Reinsurance and other risk-mitigation techniques.

Reinsurance and similar risk mitigation techniques may enable the undertaking to prudently manage and mitigate in particular the insurance specific risk. However, such techniques introduce new potential risks, such as the risk of counterparty default. The use of reinsurance and similar risk mitigation techniques constitute an ongoing process that may be used to keep the undertaking's risks within the scope of the preset risk tolerance levels.

As part of their reinsurance management strategy, undertakings should have adequate procedures and processes for the selection of suitable reinsurance programs. The level of sophistication for these processes and procedures should be proportionate to the nature, scale and complexity of the undertaking's risks and to the capabilities of the undertaking to manage and control the risk mitigation technique used. The undertaking's reinsurance management strategy should have regard to the following considerations:

- Identification of the level of risk transfer appropriate to the undertaking's approach to risk;
- What types of reinsurance arrangements are most appropriate to limit risks to the undertaking's insurance risk profile;
- Principles for the selection of reinsurance counterparties;
- Procedures for assessing the creditworthiness and diversification of reinsurance counterparties;
- Procedures for assessing the effective risk transfer;
- Concentration limits for credit risk exposure to reinsurance counterparties and appropriate systems for monitoring these exposures; and
- Liquidity management to deal with any timing mismatch between claims' payments and reinsurance recoveries.

4.2 Other risks to be considered

Although not explicitly mentioned in Article 44(2) of the Level 1 text, the following risks should also be considered due to the potential impact their realisation could have on the business of the undertaking.

(a) Credit risk

Credit risk is included in the calculation of the SCR. Credit risk refers to the risk of loss, or of adverse change in the financial situation resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors to which insurance and reinsurance undertakings are exposed, in the form of counterparty default risk, or spread risk, or market risk concentrations.

Credit risk is a function of exposure at default, probability of default and loss given default. A credit risk management strategy should, at a minimum, focus on these elements both in isolation and on the correlations between them. The undertaking should ensure that the credit risk exposure is sufficiently diversified. It should have a process of credit risk management to ensure that exposure to any counterparty is limited so that no single exposure would threaten the undertaking's solvency position. The process of risk management should be capable of identifying, measuring and mitigating any credit risk in relation to internally defined limits.

(b) Strategic risk

Strategic risk is defined as the risk of the current and prospective impact on earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes.

Strategic risk is a function of the incompatibility between two or more of the following components: the undertaking's strategic goals; the business strategies developed and the resources deployed to achieve these goals, and the quality of implementation and the economic situation of the markets the undertaking operates in.

(c) Reputational risk

Reputational risk is defined as the risk of potential loss to an undertaking through deterioration of its reputation or standing due to a negative perception of the undertaking's image among customers, counterparties, shareholders and supervisory authorities. To that extent it may be regarded as less of a separate risk, than one consequent on the overall conduct of an undertaking. The administrative, management or supervisory body of the undertaking should be aware of potential reputational risks it is exposed to and the correlation with all other material risks.

5. The Own Risk and Solvency Assessment (ORSA) - Article 45

Article 45 of the Level 1 text states:

1. As part of its risk-management system every insurance undertaking and reinsurance undertaking shall conduct its own risk and solvency assessment.

That assessment shall include at least the following:

(a) the overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the undertaking;

(b) the compliance, on a continuous basis, with the capital requirements, as laid down in Chapter VI, Sections 4 and 5 and with the requirements regarding technical provisions, as laid down in Chapter VI, Section 2;

(c) the significance with which the risk profile of the undertaking concerned deviates from the assumptions underlying the Solvency Capital Requirement as laid down in Article 101(3), calculated with the standard formula in accordance with Chapter VI, Section 4, Subsection 2 or with its partial or full internal model in accordance with Chapter VI, Section 4, Subsection 3.

2. For the purposes of paragraph 1(a), the undertaking concerned shall have in place processes which are proportionate to the nature, scale and complexity of the risks inherent in its business and which enable it to properly identify and assess the risks it faces in the short and long term and to which it is or could be exposed. The undertaking shall demonstrate the methods used in that assessment.

3. In the case referred to in paragraph 1(c), when an internal model is used, the assessment shall be performed together with the recalibration that transforms the internal risk numbers into the Solvency Capital Requirement risk measure and calibration.

4. The own-risk and solvency assessment shall be an integral part of the business strategy and shall be taken into account on an ongoing basis in the strategic decisions of the undertaking.

5. Insurance and reinsurance undertakings shall perform the assessment referred to in paragraph 1 regularly and without any delay following any significant change in their risk profile.

6. The insurance and reinsurance undertakings shall inform the supervisory authorities of the results of each own-risk and solvency assessment as part of the information reported under Article 35.

7. The own-risk and solvency assessment shall not serve to calculate a capital requirement. The Solvency Capital Requirement shall be adjusted only in accordance with Articles 37, 231 to 233 and 238.

Under Article 45, as part of the risk management system, undertakings are required to undertake an assessment of the risks they have within their business and the level of solvency required to mitigate those risks. As stated in CEIOPS Issues paper[5] the ORSA 'can be defined as the entirety of the processes and procedures employed to identify, assess, monitor, manage and report the short and long term risks a (re)insurance undertaking faces or may face and to determine the own funds necessary to ensure that the undertaking's overall solvency needs are met at all times'. A robust risk management function will assist the undertaking to take on a robust ORSA, which links together the undertaking's own view of the risks it has within its business and its own solvency needs.

The ORSA is an internal risk assessment process that aims to ensure senior management have conducted their own review of the risks to which they are exposed and that they hold sufficient capital against those risks. The ORSA must reflect the undertakings' own risk appetite, which means that many undertakings may wish to target a higher confidence level (or a longer time horizon) than the level at which the SCR is set under Solvency II (99.5%).

The ORSA should be an integral part of managing the business against the undertaking's chosen strategy and it should thus be an important tool in assisting strategic decision-making. Demonstration of this activity will be important. Given the requirement for the integrated management of risk and capital, when making changes (for example, to their business strategy and/or the undertaking's risk tolerance) senior management should demonstrate that they have considered the effects on their solvency needs and record this in their ORSA.

The ORSA is not subject to regulatory approval, but the results of each assessment will need to be advised to the MFSA and will form part of ongoing regulatory activities. The ORSA is a requirement for all firms whether using the standard formula or an internal model to calculate regulatory capital requirements. An ORSA does not require an internal model, but where an internal model is used it is an integral tool to the ORSA process and the same assumptions should be used in both the ORSA and the internal model to ensure consistency.

The CEIOPS Issues Paper indicates that the sophistication and extent of the ORSA should be proportionate to the nature, scale and complexity of the risks within the undertaking. While there may be undertakings using the SCR standard formula for which, owing to their size and complexity, the ORSA process necessitates a design not far removed in sophistication from an internal model, this will not apply to all undertakings. Standard formula users with less complex risk profiles may use less sophisticated tools to implement the ORSA.

However, it should be recognized that the ORSA exercise could promote the use of more sophisticated methods, since it requires undertakings to become more cognisant of the interrelationships between the risks within their business and their overall solvency needs.

It can be expected that, with this increased insight, undertakings will seek to improve their ability to assess and manage their risks and control their overall solvency needs and thus enhance their efficiency by introducing more advanced processes, methods and techniques.

[5] CEIOPS' Issues Paper on the Own Risk and Solvency Assessment (May 2008) which provided further guidance to firms about what could be envisaged for the ORSA.

The purpose of the ORSA is to ensure that undertakings have robust processes for assessing and monitoring their overall solvency needs, not to duplicate, validate or analyse in detail the parameterisation of the SCR calculation. The following sections include certain aspects that should be taken into account in the ORSA, but are not meant to be an exhaustive list.

(a) The overall solvency needs

The term "overall solvency needs" includes the assets necessary to cover the liabilities including technical provisions, the regulatory capital requirements – SCR and MCR – as well as the internal capital needs.

Whereas the regulatory capital requirements can only be covered by eligible own funds, other elements of capital may be taken into account to cover an undertaking's internal capital needs.

Furthermore, Article 45 (2) states that an undertaking should not only assess its current risks but also the risks it faces in the long term. That means that long term projections of the business which are a key part of any undertaking's financial planning, such as projections of business plans, economic balance sheet and profit and loss account, are required.

These projections should feed into the ORSA in order to enable the undertaking to form an opinion on the future overall solvency needs and own funds. Suitable capital planning should include projections of capital requirement and own funds (e.g. raising new own funds).

It is up to the undertaking to decide on reasonable assumptions, parameters, correlations or levels of confidence to be used in the projections. However, Level 3 Guidance may provide some direction on the minimum contents supervisors should expect from the ORSA in this respect.

An undertaking should also identify and take into account external factors that could have an adverse effect on its overall solvency needs or its own funds. These external factors can be changes in the economic conditions, changes in the legal environment, changes in the insurance market, technical developments that have an impact on the underwriting risk or any other event the crystallisation of which is sufficiently probable that it be considered by a prudent person.

When assessing its overall solvency needs, an undertaking should also take into account management actions that may be adopted by the undertaking in unfavourable economic conditions. Particular consideration should be given to whether these management actions will operate as planned under such unfavourable economic conditions.

In the Supervisory Review Process (SRP), supervisors may also challenge the bases for the projections and an undertaking should be prepared to explain the rationale for selecting them and demonstrate that its methods and practices are appropriate.

(b) Compliance on a continuous basis

The undertaking is responsible for having sufficient eligible own funds to cover the MCR and the SCR on a continuous basis.

The ORSA should include an assessment as to whether the undertaking holds sufficient eligible own funds determined in accordance with the Directive at any time over the business planning time horizon.

CEIOPS' interpretation of "on a continuous basis" in Article 45 (1) (b) of the Framework Directive Proposal is that it refers to compliance and not to the required assessment, i.e. the paragraph does not constitute an obligation to constantly recalculate the SCR and MCR.

In order to ensure that the capital requirements are met at all times, the undertaking needs to have processes in place that enable it to estimate the changes in its capital requirements and eligible own funds' level since the last full solvency calculation.

How often such a full calculation is to be performed will depend particularly on the volatility of the capital requirements and the own funds, as well as on the level of solvency.

The undertaking should be able to justify the adequacy of the frequency of the calculation taking into account its risk profile. A full calculation is in any case required if the risk profile changes significantly.

The assessment of the overall solvency needs should not only focus on the amount of own funds needed going forward, but also on the quality of the own funds, especially those needed to comply with the capital requirements, and the ability to raise more own funds.

(c) Assessment of the risk profile

The undertaking's ORSA should consider all risks that may lead to a material reduction in the current level of own funds or the protection offered to policyholders. Due consideration must be given to the risks included in the calculation of the SCR, as well as the risks which are not (or not fully) captured in the SCR calculation. Areas considered should therefore at least cover underwriting, market, credit and operational risks, as well as any other material risks[6] (e.g. liquidity, reputational, strategic). Consideration should also be given to the impact of risk mitigation techniques, including reinsurance, any diversification effect between risks (correlations), and to the actual loss-absorbing capacity of technical provisions and deferred taxes.

The undertaking's ORSA should include an assessment of the adequacy of the undertaking's governance system and take into consideration any risks that may arise from any inadequacy or deficiency.

The assessment includes an analysis of the differences, if any, between the amount of own funds which the undertaking considers necessary for its business needs and the capital requirement the SCR generates.

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[6] See Sections 4.1 and 4.2

There are a number of reasons why differences between internal capital needs and regulatory solvency capital requirement may exist, such as:

(i) The undertaking may operate at a different confidence level for business purposes compared to the regulatory assumptions on which the SCR calculation is based.

For instance, it may choose to hold own funds for rating purposes, which represents a higher confidence level than that used to calibrate the SCR.

(ii) The undertaking's risk profile may differ from the one implicit in the SCR.

For instance, the undertaking's assessment of the capital needed to back a particular insurance risk might be different from the assessment on which the parameters of the SCR calculation are based or the undertaking's risk profile may include risks which are not covered by the SCR.

(iii) In the ORSA the undertaking may use a time horizon for its business planning purposes that differs from the time horizon underlying the SCR.

(iv) In the ORSA the undertaking may consider any agreed management actions that could influence the risk profile.

Although an undertaking, in performing its ORSA, may for its own business purposes use a confidence level or a time horizon that differs from that of the SCR calculation, it is also required to perform the internal calculation on the basis of a 99.5% confidence level and a one-year time horizon, in order to assess the deviation of its risk profile from the assumptions underlying the SCR calculation, as required by Article 45 (1) (c).

An internal model is in itself a tool for the ORSA. For an undertaking using an internal model to calculate the SCR, the ORSA should include a description of the role of the internal model in the integrated management of risk and capital needs. An undertaking should be able to justify the continued adequacy of the model compared with the risk profile of the undertaking.

When the internal model is calibrated for a different time horizon and/or a different level of confidence from the SCR standard formula, the ORSA should give information both on the internal capital needs identified for the undertaking's internal purposes and on the regulatory capital requirements.

(d) Long term considerations of the ORSA

The ORSA should be forward-looking, taking into account the undertaking's business plans and projections. In this respect, an undertaking should not only assess its current risks but also the risks it faces in the long term. That may mean that depending on the complexity of the undertaking's business, long term projections of the business which are a key part of any undertaking's financial planning, including business plans and projections of economic

balance sheet and profit and loss account, may be required. These projections should feed into the ORSA in order to enable the undertaking to form an opinion on the future overall solvency needs and own funds.

An undertaking should also identify and take into account external factors that could have an adverse impact on its overall solvency needs or its own funds. External factors that could have an adverse effect on undertakings can, for example, be changes in the economic conditions, in the legal environment, in the insurance market, technical developments that have an impact on the underwriting risk or any other event the crystallisation of which is sufficiently probable that it should be considered by a prudent person.

Suitable capital planning should include projections of capital requirements and own funds (e.g. raising new own funds). It is up to the undertakings to decide on reasonable assumptions, parameters, correlations or levels of confidence to be used in the projections.

(e) The outcome of the ORSA

If the outcome of the ORSA is that the internal capital needs differ in either direction from the amount resulting from the SCR, the undertaking should explain the reasons and individually identify any impact on the calculation of the solvency capital requirement.

If the outcome from the ORSA is that the internal capital needs are higher than the regulatory capital, this does not automatically mean that the undertaking will have a capital add-on imposed by the supervisor.

Supervisors will look into the reasons for the differences and discuss their views with the undertaking concerned before taking any decisions. For example, the use of a different time horizon or a different confidence level would not result in an add-on.

Any changes the undertaking plans to introduce in order to reduce its risk profile as a consequence of the ORSA process would also be duly considered by supervisors.

Before setting a capital add-on, supervisors would moreover not only take into account the ORSA results but also the full results of SRP.

Supervisors are not empowered to allow a reduction of the SCR as calculated in accordance with the standard formula if an undertaking demonstrates in its ORSA that the SCR calculation overestimates its risks.

If the outcome from the ORSA is that the internal capital needs are considerably lower than the SCR, the undertaking may wish to consider whether it is appropriate to develop a partial or a full internal model and seek supervisory approval for its use in the calculation of the SCR.

(f) Integration of the ORSA

The requirement under Article 45 (4), for the ORSA to be an integral part of the business strategy, calls for an undertaking to have in place its own strategies for internal capital

needs and all material risks to which it is exposed (such as underwriting, credit, market, liquidity, concentration and operational risks), as well as an appropriate policy for the use of risk mitigation and transfer arrangements (e.g. reinsurance and derivatives) that together manage and address overall solvency needs.

The ORSA and the business strategy affect each other.

When performing the ORSA, the undertaking should take into account the business strategy and any strategic decisions influencing the risk and overall solvency needs.

In reverse, the administrative or management body needs to be aware of the implications strategic decisions have on the risk and overall solvency needs of the undertaking and to consider whether these effects are desirable and affordable. In this respect, it is imperative that the administrative or management body is actively involved in the review and challenge of the ORSA.

Any strategic decision that may affect the risk and/or own funds' position of the undertaking should be considered through the ORSA process before such a decision is taken.

(g) Frequency of the ORSA

Article 45 (5) requires insurance and reinsurance undertakings to perform the assessment regularly and without any delay following any significant change in their risk profile.

CEIOPS interprets the word "regularly" to mean at least annually in this context. The ORSA would also need to be performed within that period if an undertaking experiences a change in the risk and solvency profile that may impact the ORSA result in a way that the undertaking should be aware of.

The undertaking should establish its own frequency of the assessment taking into account its own risk profile. It should be able to justify the adequacy of the frequency of the assessment.

(h) Internal documentation and independent assessment of the ORSA

The ORSA process and outcome should be appropriately documented.

Internal documentation should at a minimum include:

For the ORSA process:

a) A description of the areas included in the ORSA;
b) A description of the process of conducting the ORSA and the responsibilities of key personnel involved in the process;
c) Stress tests used and their results;
d) Assumptions used in assessing and aggregating risks;
e) A description of the data sources;

f) Criteria and methodologies to assess the quality of the data used;
g) A description of the independent assessment and the results of the last assessment;
h) Frequency and contents of the internal reporting.

With regard to the outcome:

i) The amount of overall solvency needs, MCR and SCR and the financial condition of the undertaking, signed-off by the management body;
j) Any strategies for raising additional own funds where necessary;
k) The conclusions on the comparison of the undertaking's risk profile compared to the assumptions underlying the standard formula or internal model respectively.

Where assumptions are different from those used in the SCR calculation, the differences for them should be clearly identified and explained.

The undertaking should ensure that the ORSA can be easily reviewed by the supervisory authority as part of the SRP. As such, documentation should be compiled in a way that can easily be shared with the supervisory authority.

The ORSA is part of the system of governance and as such subject to a regular internal review. The management body has to ensure that this regular assessment of the ORSA process is performed by persons that have not been responsible for the part of the ORSA process they review and who are thus independent in their assessment. The conclusions drawn from the independent assessment should be reported to the administrative, or management or supervisory body in order to enable it to act on this information if necessary.

(i) Information on the result of the ORSA to supervisory authorities

Article 45 (6) requires undertakings to inform the supervisory authorities of the results of each own risk and solvency assessment as part of the information reported under Article 35.

Information about the ORSA process and the outcome of the ORSA is also a supervisory tool that will be used, together with other items of the supervisory reporting, as part of the SRP, to enable supervisors to:

(i) Assess the ability of the undertaking to assess its overall solvency needs; and
(ii) To better understand the risks to which the undertaking is or may be exposed.

6. Internal control - Article 46

Article 46 of the Level 1 text states:

1. Insurance and reinsurance undertakings shall have in place an effective internal control system.

That system shall at least include administrative and accounting procedures, an internal control framework, appropriate reporting arrangements at all levels of the undertaking and a compliance function.

2. The compliance function shall include advising the administrative, management or supervisory body on compliance with the laws, regulations and administrative provisions adopted pursuant to this Directive. It shall also include an assessment of the possible impact of any changes in the legal environment on the operations of the undertaking concerned and the identification and assessment of compliance risk.

Internal control is defined as a process affected by an organisation's structure, work and authority flows, people and management information systems, designed to help the organisation accomplish specific goals or objectives.

A system of effective internal control is a critical component of undertaking management and a foundation for the safe and sound operation of undertakings. Internal control is not a procedure or policy performed at a certain point in time, but rather a set of continually operating processes involving the administrative, management or supervisory body and all levels of personnel.

The internal control system shall secure the undertaking's compliance with applicable laws, regulations and administrative provisions and the effectiveness and efficiency of operations in view of its objectives as well as the availability and reliability of financial and non-financial information.

The undertaking shall be required to have in place:

(i) A suitable control environment

The internal control system of the undertaking should be built upon a strong control culture which emphasises and demonstrates to all levels of personnel the importance of internal control.

(ii) Appropriate control activities

The daily control activities could, depending on the particular circumstances of the undertaking, include approvals, authorisations, verifications, reconciliations, management reviews, appropriate measurements applicable to each business area and unit, physical controls, checking for compliance with agreed exposure limits and operating principles/instructions and follow-up on non-compliance. The control activities should be proportionate to the risks coming from the controlled activities and processes.

(iii) Effective information and communication procedures

The reporting of the achievement of the main goals and material risks inherent in the business should be predefined. This applies particularly to the reporting to the administrative, management or supervisory body.

(iv) Adequate monitoring mechanisms.

The monitoring mechanisms shall facilitate the understanding of the undertaking's situation and provide the administrative, management or supervisory body with relevant information for the decision-making process. They should include procedures to detect deficiencies. Ongoing monitoring should occur in the course of normal operations and should include regular management activities and actions taken by all personnel when performing their duties.

Article 46(1) requires undertakings to have in place a compliance function as part of the internal control system. The compliance function within the undertaking is the administrative capacity for ensuring that all the actions of the undertaking comply with applicable laws and regulatory requirements. The compliance function could also ensure that the undertaking complies with internal strategies, policies, processes and reporting procedures.

Compliance Function

The compliance function should identify, assess, monitor and report the compliance risk exposure of the undertaking. Compliance risk is defined as the risk of legal or regulatory sanctions, material financial loss or loss to reputation an undertaking may suffer as a result of not complying with laws, regulations and administrative provisions as applicable to its activities.

According to Article 46(2) the compliance function is also required to advise the administrative, management or supervisory body on compliance with the applicable laws, regulations and administrative provisions adopted pursuant to the Level 1 text. The compliance function could also ensure that the undertaking complies with other applicable laws and regulations whether insurance specific or not.

The intended compliance activities shall be set out in a compliance plan that ensures that all relevant areas of the undertaking are appropriately covered, taking into account their susceptibility to compliance risk. The compliance function shall promptly report any major compliance problems that it identifies to the administrative, management or supervisory body.

7. Internal audit function - Article 47

Article 47 of the Level 1 text states:

1. Insurance and reinsurance undertakings shall provide for an effective internal audit function.

The internal audit function shall include an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance.

2. The internal audit function shall be objective and independent from the operational functions.

3. Any findings and recommendations of the internal audit shall be reported to the administrative, management or supervisory body which shall determine what actions are to be taken with respect to each of the internal audit findings and recommendations and shall ensure that those actions are carried out.

The internal audit function is an independent function within the organization which examines and evaluates the functioning of the internal controls and all other elements of the system of governance, as well as the compliance of activities with internal strategies, policies, processes and reporting procedures.

The internal audit function needs to be independent from the organizational activities audited and carry out its assignments with impartiality. The principle of independence entails that the internal audit function should only operate under the oversight of the administrative, management or supervisory body, reporting to this body or an audit committee. At the same time it has to be ensured that the internal audit function is not subject to instructions of the administrative, management or supervisory body when performing the audit and when evaluating and reporting the audit results.

The internal audit function needs to be provided with a complete and unrestricted right to obtain information, which includes the prompt provision of all necessary information, the availability of all essential documentation and the ability to see into all activities and processes of the undertaking, relevant for the discharge of its responsibilities. It needs to be granted access to any records, files or data of the undertaking, including management information and the minutes of decision-making bodies whenever relevant for the performance of its tasks.

The internal audit function will have to at least annually produce a written report on its findings to be submitted to the administrative, management or supervisory body. This report should cover any deficiencies with regard to the efficiency and suitability of the internal control system, as well as major shortcomings with regard to the compliance with internal policies, procedures and processes. It should include recommendations on how to remedy inadequacies and should also describe how any past points of criticism and past recommendations have been implemented.

8. Actuarial function - Article 48

Article 48 of the Level 1 text states:

> *1. Insurance and reinsurance undertakings shall provide for an effective actuarial function to:*
>
> *(a) coordinate the calculation of technical provisions;*
>
> *(b) ensure the appropriateness of the methodologies and underlying models used as well as the assumptions made in the calculation of technical provisions;*
>
> *(c) assess the sufficiency and quality of the data used in the calculation of technical provisions;*
>
> *(d) compare best estimates against experience;*
>
> *(e) inform the administrative, management or supervisory body of the reliability and adequacy of the calculation of technical provisions;*
>
> *(f) oversee the calculation of technical provisions in the cases set out in Article 82;*
>
> *(g) express an opinion on the overall underwriting policy;*
>
> *(h) express an opinion on the adequacy of reinsurance arrangements; and*
>
> *(i) contribute to the effective implementation of the risk-management system referred to in Article 44, in particular with respect to the risk modelling underlying the calculation of the capital requirements set out in Chapter VI, Sections 4 and 5, and to the assessment referred to in Article 45.*
>
> *2. The actuarial function shall be carried out by persons who have knowledge of actuarial and financial mathematics, commensurate with the nature, scale and complexity of the risks inherent in the business of the insurance or reinsurance undertaking, and who are able to demonstrate their relevant experience with applicable professional and other standards.*

The requirement for an actuarial function will also represent a change for many undertakings. Currently the MFSA has requirements for the use of actuaries in life insurance undertakings, while nothing is prescribed for undertakings writing non-life business. The Directive requires all insurance undertakings to have an actuarial function and Article 48(1) is explicit about the roles that the actuarial function is required to undertake. Some of these roles may not traditionally be within the remit of the actuarial work within undertakings. Insurers should be preparing to introduce an actuarial function if they do not currently have one and for it to be involved in the specified areas and any future implementing measures.

CEIOPS views access to actuarial knowledge as 'indispensable to an adequate system of governance'. It may not be necessary for this function to be carried out by someone with

specific vocational or professional training, but should be 'carried out by persons with sufficient knowledge of actuarial and financial mathematics and… able where appropriate to demonstrate their relevant experience and expertise…'

Set out below is an explanation of the additional scope of the tasks listed in Article 48(1).

(i) Calculation of technical provisions

Article 48(1)(a) requires the actuarial function to coordinate the calculation of the technical provisions. In order to accomplish this task it should, at least:

(a) Apply methodologies and procedures to assess the sufficiency of technical provisions ensuring that their calculation is consistent with the underlying principles;

(b) Assess the uncertainty associated with the estimates;

(c) Produce judgement whenever this is needed, making use of appropriate information and experience of the persons that are in charge of the function;

(d) Ensure that problems related to the calculation of technical provisions arising from insufficient data quality are dealt with appropriately and that, where it is impracticable to apply common methods of calculating technical provisions because of insufficient data quality, the most appropriate alternatives to common methods applied are found, taking into consideration the principle of proportionality;

(e) Ensure that homogeneous risk groups for an appropriate assessment of the underlying risks are identified;

(f) Consult any relevant market information and ensure that it is integrated into the assessment of technical provisions;

(g) Compare and justify any material differences among the estimates for different years; and

(h) Ensure that an appropriate assessment of options and guarantees embedded in liabilities is provided.

(ii) Appropriateness of the methodologies and underlying models used as well as the assumptions made in the calculation of technical provisions

In relation to Article 48(1)(b), in order to ensure the appropriateness of the underlying methodologies and models, the actuarial function not only has to assess the general suitability of the methodology or underlying model for the calculation of technical provisions as such, but also has to decide whether they are appropriate for the specific lines of business of the undertaking, for the way the business is managed and for the available data.

(iii) Sufficiency and quality of the data used in the calculation of technical provisions

While assessing the sufficiency and quality of the data under Article 48(1)(c), the actuarial function should have regard to the objectivity, reasonability and verifiability of management actions included in the calculation of technical provisions. It should also assess whether information technology systems used in actuarial procedures sufficiently support these procedures. However, data auditing is a task that should be performed not by the actuarial function but by the internal audit function.

(iv) Comparison of best estimates against experience

The comparison of the best estimates against experience under Article 48(1)(d) requires the actuarial function to assess whether past best estimates have proved sufficient and to use the insights gained in this assessment to improve the quality of present best estimate calculations.

This analysis should also include comparisons between observed values and the assumptions used in the calculation of technical provisions in order to produce conclusions on the appropriateness of the data used and the methodologies applied on their estimation.

(v) Informing the administrative, management or supervisory body of the reliability and adequacy of the calculation of technical provisions

Article 48(1)(e) is not limited to expressing an opinion on the reliability and adequacy of the calculation of technical provisions but would include the degree of uncertainty about the ultimate outcome and the circumstances that might lead to a significant deviation from the provisions made. The actuarial function must also set out how it arrived at its opinion and clearly state and explain any concerns it may have as to the technical provisions being sufficient.

(vi) Case-by-case approach to the calculation of technical provisions

In the scope of the coordination of the calculation of technical provisions, the actuarial function should, as under Article 48(1)(f), oversee when a case-by-case approach should be followed, that is, when there is not sufficient quality of data to apply a reliable actuarial method. Also, it has to produce judgement to establish assumptions and to safeguard the accuracy of the results.

(vii) Opinion on the overall underwriting policy and on the adequacy of reinsurance arrangements

Regarding the overall underwriting policy, the opinion to be expressed by the actuarial function shall at least include the following issues:

(a) Sufficiency of the premiums to cover future losses, notably taking into consideration the underlying risks (including underwriting risks), the impact of expenses directly associated with future claims and of unallocated loss adjustment expenses and the impact of embedded options and guarantees on future liabilities; and

(b) Considerations regarding inflation, legal risk, change of mix, anti-selection and adequacy of bonus-malus system(s) implemented in specific line(s) of business.

Regarding the overall reinsurance arrangements, the opinion to be expressed by the actuarial function shall include an opinion on the adequacy of the significant reinsurance arrangements as well as expected cover under stress scenarios in relation to the underwriting policy and the adequacy of the calculation of the technical provisions arising from reinsurance.

In order to be able to provide its opinions free from influence from other functions and the administrative, management or supervisory body, the actuarial function shall be constituted by persons who have a sufficient level of independency.

In forming and formulating its own actuarial view the actuarial function shall be objective and free from influence of other functions and the administrative, management or supervisory body.

The actuarial function shall at least annually produce written reports to be submitted to the administrative, management or supervisory body. The reports shall document the tasks that have been undertaken, clearly state any shortcomings identified and give recommendations as to how the deficiencies could be remedied.

(viii) Contribution to the effective implementation of the risk-management system

The fact that the actuarial function shall "contribute to the effective implementation of the risk management system", and that according to Article 44(4) the risk management function shall facilitate the implementation of the risk management system, does not imply that both functions should be organised as different organisational units. A full or partial integration of these functions is acceptable.

An effective risk management system requires input from the actuarial function (e.g. in the quantification and modelling of risks). This is not limited to a contribution to the ORSA or an internal model, if any, but includes also an involvement in e.g. asset-liability management, and risk mitigation arrangements.

9. Outsourcing - Articles 38 & 49

Article 38 of the Level 1 text states:

1. Without prejudice to Article 49, Member States shall ensure that insurance and reinsurance undertakings which outsource a function or an insurance or reinsurance activity take the necessary steps to ensure that the following conditions are satisfied:

(a) the service provider must cooperate with the supervisory authorities of the insurance and reinsurance undertaking in connection with the outsourced function or activity;

> *(b) the insurance and reinsurance undertakings, their auditors and the supervisory authorities must have effective access to data related to the outsourced functions or activities;*
>
> *(c) the supervisory authorities must have effective access to the business premises of the service provider and must be able to exercise those rights of access.*
>
> *2. The Member State where the service provider is located shall permit the supervisory authorities of the insurance or reinsurance undertaking to carry out themselves, or through the intermediary of persons they appoint for that purpose, on-site inspections at the premises of the service provider. The supervisory authority of the insurance or reinsurance undertaking shall inform the appropriate authority of the Member State of the service provider prior to conducting the on-site inspection. In the case of a non-supervised entity the appropriate authority shall be the supervisory authority.*
>
> *The supervisory authorities of the Member State of the insurance or reinsurance undertaking may delegate such on-site inspections to the supervisory authorities of the Member State where the service provider is located.*

Article 49 of the Level 1 text states:

> *1. Member States shall ensure that insurance and reinsurance undertakings remain fully responsible for discharging all of their obligations under this Directive when they outsource functions or any insurance or reinsurance activities.*
>
> *2. Outsourcing of critical or important operational functions or activities shall not be undertaken in such a way as to lead to any of the following:*
>
> *(a) materially impairing the quality of the system of governance of the undertaking concerned;*
>
> *(b) unduly increasing the operational risk;*
>
> *(c) impairing the ability of the supervisory authorities to monitor the compliance of the undertaking with its obligations;*
>
> *(d) undermining continuous and satisfactory service to policy holders.*
>
> *3. Insurance and reinsurance undertakings shall, in a timely manner, notify the supervisory authorities prior to the outsourcing of critical or important functions or activities as well as of any subsequent material developments with respect to those functions or activities.*

Outsourcing in the context of the Level 1 text means an arrangement of any form between an insurance or reinsurance undertaking and a service provider, whether a supervised entity or not, by which that service provider performs a process, a service or an activity, whether directly or by sub-outsourcing, which would otherwise be performed by the insurance or reinsurance undertaking by itself.

A service provider may be a supervised entity, it may or may not be an entity from the same group as the undertaking (internal outsourcing) and it may be located within the EU as well as outside.

In principle all functions and activities of a (re)insurance undertaking can be outsourced provided its administrative, management or supervisory body retains ultimate responsibility for discharging its obligations.

Not every provision of a function or service to an undertaking by a service provider will fall within the meaning of outsourcing above. Hiring a specialist consultant to provide one-off technical advice does not constitute outsourcing, though it may become so if the undertaking subsequently relies on that consultant to manage an internal function or service, e.g. when it is installed or becomes fully operational. CEIOPS would expect to elaborate further on what might or might not constitute outsourcing in Level 3 guidance.

As the undertaking remains fully responsible for all outsourced functions and activities it needs to include in its risk management systems and controls a process for monitoring and reviewing the quality of the service provided. It is not sufficient for the service provider itself to have internal controls and a risk management system that covers the services performed. In order to ensure effective control of outsourced activities and manage the risks associated with the outsourcing, the undertaking needs to maintain the competence and ability within the undertaking to assess whether the service provider delivers according to contract.

To ensure that the outsourcing of any critical or important functions or activities does not lead to a material impairment of the quality of the undertaking's governance system:

(a) The undertaking must ensure that the service provider has in place an adequate risk management and internal control system;

(b) The outsourced activities must be adequately included in the undertaking's risk management and internal control system; and

(c) The undertaking must establish a contractual right to information about the outsourced activities and a contractual right to issue instructions concerning the outsourced activities.

In order to ensure against an undue increase in operational risk, when outsourcing critical or important functions or activities the outsourcing undertaking should:

(a) Verify that the service provider has adequate financial resources to take on the additional tasks the undertaking plans to transfer and to properly and reliably discharge its duties towards the undertaking and that the staff of the service provider is chosen on the basis of criteria that give reasonable assurance that they are sufficiently qualified and reliable;

(b) Verify that the service provider properly isolates and identifies the information, documentation and assets belonging to the undertaking and its clients in order to protect their confidentiality; and

(c) Make sure the service provider has adequate contingency plans in place to deal with emergency situations or business disruptions and has periodic testing of backup facilities where that is necessary having regard to the function, service or activity outsourced.

In order to ensure that the outsourcing of critical or important functions or activities does not impair the ability of the supervisory authorities to monitor the compliance of the undertaking with its obligations under the Level 1 text, it must comply with Article 38 of the Level 1 text and must ensure:

(a) The service provider's cooperation with the supervisory authorities of the undertaking in connection with the outsourced functions or activities;

(b) The undertaking, its auditors and the relevant supervisory authorities have effective access to data related to the outsourced functions or activities; and

(c) The supervisory authorities have effective access to the business premises of the service provider and are able to exercise this right.

10. Capital add-on - Article 37

Article 37 of the Level 1 text states:

1. Following the supervisory review process supervisory authorities may in exceptional circumstances set a capital add-on for an insurance or reinsurance undertaking by a decision stating the reasons. That possibility shall exist only in the following cases:

(a) the supervisory authority concludes that the risk profile of the insurance or reinsurance undertaking deviates significantly from the assumptions underlying the Solvency Capital Requirement, as calculated using the standard formula in accordance with Chapter VI, Section 4, Subsection 2 and:

(i) the requirement to use an internal model under Article 119 is inappropriate or has been ineffective; or

(ii) while a partial or full internal model is being developed in accordance with Article 119;

(b) the supervisory authority concludes that the risk profile of the insurance or reinsurance undertaking deviates significantly from the assumptions underlying the Solvency Capital Requirement, as calculated using an internal model or partial internal model in accordance with Chapter VI, Section 4, Subsection 3, because certain quantifiable risks are captured insufficiently and the adaptation of the model to better reflect the given risk profile has failed within an appropriate timeframe; or

(c) the supervisory authority concludes that the system of governance of an insurance or reinsurance undertaking deviates significantly from the standards laid down in Chapter IV, Section 2, that those deviations prevent it from being able to properly identify, measure, monitor, manage and report the risks that it is or could be exposed to and that the application of other measures is in itself unlikely to improve the deficiencies sufficiently within an appropriate timeframe.

2. In the circumstances set out in points (a) and (b) of paragraph 1 the capital add-on shall be calculated in such a way as to ensure that the undertaking complies with Article 101(3).

In the circumstances set out in paragraph 1(c) the capital add-on shall be proportionate to the material risks arising from the deficiencies which gave rise to the decision of the supervisory authority to set the add-on.

3. In the cases set out in points (b) and (c) of paragraph 1 the supervisory authority shall ensure that the insurance or reinsurance undertaking makes every effort to remedy the deficiencies that led to the imposition of the capital add-on.

4. The capital add-on referred to in paragraph 1 shall be reviewed at least once a year by the supervisory authority and be removed when the undertaking has remedied the deficiencies which led to its imposition.

5. The Solvency Capital Requirement including the capital add-on imposed shall replace the inadequate Solvency Capital Requirement.

Notwithstanding the first subparagraph the Solvency Capital Requirement shall not include the capital add-on imposed in accordance with paragraph 1(c) for the purposes of the calculation of the risk margin referred to in Article 77(5).

6. The Commission shall adopt implementing measures laying down further specifications for the circumstances under which a capital add-on may be imposed and the methodologies for the calculation thereof.

Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).

The Directive gives supervisors the ability to set a capital add-on in those circumstances where the supervisor believes an undertaking is not holding adequate capital.

The capital add-on, plus the undertaking-calculated SCR, will replace the original SCR to become the new capital requirement undertakings must meet. Capital add-ons may be

appropriate in various circumstances as outlined in Article 37. For example, the standard formula might not sufficiently match an undertaking's risk profile. The ORSA may indicate to supervisors that an insurer's SCR, set at a 99.5% confidence level over one year through the standard formula or internal model, is lower than its risk profile should merit.

In these circumstances, a capital add-on may be applied by the supervisor to ensure that the amount of regulatory capital an undertaking is required to hold delivers the 99.5% confidence level over one year, as specified. If material divergence is expected to persist between the results of applying the standard formula and capital requirements that properly reflect the undertaking's risk profile, Article 110 enables the supervisor to require the undertaking concerned to replace a subset of the parameters used in the standard formula calculation by parameters specific to that undertaking when calculating the life, non-life and health underwriting risk modules, as set out in Article 104(7), whereas Article 119 enables the supervisor to require the undertaking to build an internal model (or partial internal model) covering the relevant risks.

In addition, Article 37 provides for a capital add-on in situations where the system of governance within an undertaking does not meet the standards required. Effective governance systems are essential for the long-term health of the undertaking. A capital add-on under Article 37 should, therefore, be viewed as a short-term measure to give the undertaking an incentive to remedy its governance deficiencies and help protect policyholders in the interim.

Annex 1 - Glossary of abbreviations

ALM – Asset-Liability Management
CEIOPS – Committee of European Insurance & Occupational Pensions Supervisors
MCR – Minimum Capital Requirement
MFSA – Malta Financial Services Authority
ORSA – Own Risk & Solvency Assessment
SCR – Solvency Capital Requirement
SRP – Supervisory Review Process

Annex 2 – System of Governance Questionnaire

This questionnaire seeks to determine which systems, processes and procedures insurance undertakings have already implemented, or plan to implement, in preparation for Solvency II with respect to the system of governance. Undertakings are requested to answer to the following sets of questions as objectively as possible.

A. Persons responsible for key functions

Q1(a). Do you currently have persons with the skills, knowledge and expertise to fulfil the responsibility of the risk management function?

	(Tick one box only)
Yes	☐1
No, but planning to train and recruit persons by end 2012	☐2

Q1(b). Give the current and planned number of persons which fulfil/are expected to fulfil the responsibility of the risk management function?

Current no. of persons ________________

Planned no. of persons with effect from implementation of Solvency II ________________

Q2(a). Do you have persons with the skills, knowledge and expertise to fulfil the responsibility of the compliance function?

	(Tick one box only)
Yes	☐1
No, but planning to train and recruit persons by end 2012	☐2

Q2(b). Give the current and planned number of persons which fulfil/are expected to fulfil the responsibility of the compliance function?

Current no. of persons ________________

Planned no. of persons with effect from implementation of Solvency II ________________

Q3(a). Do you have persons with the skills, knowledge and expertise to fulfil the responsibility of the internal audit function?

	(Tick one box only)
Yes	☐1
No, but planning to train and recruit persons by end 2012	☐2

Q3(b). Give the current and planned number of persons which fulfil/are expected to fulfil the responsibility of the internal audit function?

Current no. of persons ________________

Planned no. of persons with effect from implementation of Solvency II ________________

Q4(a). Do you have persons with the skills, knowledge and expertise to fulfil the responsibility of the actuarial function?

	(Tick one box only)
Yes	☐1
No, but planning to train and recruit persons by end 2012	☐2

Q4(b). Give the current and planned number of persons which fulfil/are expected to fulfil the responsibility of the actuarial function?

Current no. of persons ________________

Planned no. of persons with effect from implementation of Solvency II ________________

B. Organisational structure

Q5(a). Does the undertaking have in place a risk management system?

	(Tick one box only)	
Yes,	☐1	➔ Q5(b)
No but have plans to establish one by end 2012	☐2	➔ Q6(a)

Q5(b). Which of the following risk areas are currently covered by the undertaking's risk management system?

		Yes	No
(i)	Underwriting and reserving	☐1	☐2
(ii)	Asset-liability management	☐1	☐2
(iii)	Investment in particular derivatives and similar commitments	☐1	☐2
(iv)	Liquidity and concentration risk management	☐1	☐2
(v)	Operational risk management	☐1	☐2
(vi)	Reinsurance and other risk mitigation techniques	☐1	☐2
(vii)	Credit risk	☐1	☐2
(viii)	Strategic risk	☐1	☐2
(ix)	Reputational risk	☐1	☐2

Q5(c). Do the personnel who are responsible for the risk management function have direct access to the administrative, management or supervisory body?

	(Tick one box only)
Yes	☐1
No	☐2

Q5(d). Please provide a current assessment of the adequacy of the risk management function.

	(Tick one box only)
Poor	☐1
Fair	☐2
Good	☐3
Very good	☐4

Q6(a). Has the undertaking established a compliance function?

	(Tick one box only)	
Yes,	☐1	➔ Q6(b)
No but have plans to establish one by end 2012	☐2	➔ Q7(a)

Q6(b). Do the personnel who are responsible for the compliance function have direct access to the administrative, management or supervisory body?

	(Tick one box only)
Yes	☐1
No	☐2

Q6(c). Is the compliance function able to communicate on its own initiative with any staff member and to obtain access to any records necessary to allow it to carry out its responsibilities?

	(Tick one box only)
Yes	☐1
No	☐2

Q6(d). Please provide a current assessment of the adequacy of the compliance function.

	(Tick one box only)
Poor	☐1
Fair	☐2
Good	☐3
Very good	☐4

Q7(a). Has the undertaking established an internal audit function?

	(Tick one box only)	
Yes,	☐1	➔ Q7(b)
No but have plans to establish one by end 2012	☐2	➔ Q8(a)

Q7(b). Does the internal audit function perform its duties in an autonomous, independent fashion?

	(Tick one box only)
Yes	☐1
No	☐2

Q7(c). What measures are in place to ensure the independence of the internal audit function from the organisational activities audited?

Q7(d). Does the internal audit function produce a written report on its findings to be submitted to the administrative, management or supervisory body?

	(Tick one box only)	
Yes	☐1	➔ Q7(e)
No	☐2	➔ Q7(f)

Q7(e). What is the length of the cycle to review and produce a written report on all areas?

Q7(f). Are members of staff employed in the internal audit function entrusted with tasks which are not related to auditing?

	(Tick one box only)
Yes	☐1
No	☐2

Q7(g). Are members of staff employed in other organisational units of the undertaking entrusted with internal audit tasks?

	(Tick one box only)
Yes	☐1
No	☐2

Q7(h). Please provide a current assessment of the adequacy of the internal audit function.

	(Tick one box only)
Poor	☐1
Fair	☐2
Good	☐3
Very good	☐4

Q8(a). Has the undertaking established an actuarial function?

	(Tick one box only)	
Yes,	☐1	➔ Q8(b)
No but have plans to establish one by end 2012	☐2	➔ Q9

Q8(b). Does the actuarial function currently perform the following tasks?

		Yes	No
(i)	Calculating technical provisions	☐1	☐2
(ii)	Assessing the appropriateness of the methodologies and underlying models used as well as the assumptions made in the calculation of technical provisions	☐1	☐2
(iii)	Assessing the sufficiency and quality of the data used in the calculation of technical provisions	☐1	☐2
(iv)	Comparing best estimates against experience	☐1	☐2
(v)	Informing the administrative, management or supervisory body of the reliability and adequacy of the calculation of technical provisions	☐1	☐2
(vi)	Overseeing when a case-by-case approach should be followed to the calculate technical provisions	☐1	☐2
(vii)	Providing an opinion on the overall underwriting policy and on the adequacy of reinsurance arrangements	☐1	☐2
(viii)	Contributing to the effective implementation of the risk-management system	☐1	☐2

Q8(c). Please provide a current assessment of the adequacy of the actuarial function.

	(Tick one box only)
Poor	☐1
Fair	☐2
Good	☐3
Very good	☐4

C. Risk control process

Risk Identification

Q9(a). Does the undertaking have in place appropriate processes and procedures which enable it to identify the risks it is or might be exposed to?

	(Tick one box only)	
Yes	☐1	➔ Q9(b)
No	☐2	➔ Q10(a)

Q9(b). Risk drivers can be classified into internal and external factors which influence the risk. Are the following categories of risk drivers taken into account?

	Yes	No
<u>Internal Factors</u>		
Internal structure (organisational and operational)	☐1	☐2
Different business activities and complexity of business	☐1	☐2
<u>External Factors</u>		
Sector-specific changes	☐1	☐2
Changes in capital markets	☐1	☐2
New or revised legal and regulatory requirements	☐1	☐2
Technical development	☐1	☐2

Q9(c). Which of the following methods and processes of risk identification does the undertaking employ?

	(You may tick more than one box)
Structured assessments (e.g. business plan risk assessment)	☐1
Scenario analyses (defined scenarios using various confounders)	☐2
Checklists	☐3
Standardised questionnaires	☐4
Trend analyses	☐5
Expert evaluations/workshops	☐6
Interviews	☐7
Other (please specify below)	☐8

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Q9(d). Are the results of the risk identification process systematically recorded in a risk description, risk catalogue or risk register?

	(Tick one box only)
Yes	☐1
No	☐2

Q9(e). Does the undertaking record for each identified risk detailed information on the following?

	Yes	No
Risk type	☐1	☐2
The responsible business unit/s	☐1	☐2
Risk drivers (e.g. share prices)	☐1	☐2
Key reference figures	☐1	☐2
Possible interactions and correlations with other risks	☐1	☐2
Measures already initiated or ongoing	☐1	☐2
Foreseeable future risks	☐1	☐2

Q9(f). How often are reviews to data recording carried out? (ie. quarterly, semi-annually, annually etc.)

Risk analysis and evaluation

Q10(a). Does the undertaking have in place an appropriate risk analysis and evaluation process?

	(Tick one box only)	
Yes	☐1	➔ Q10(b)
No	☐2	➔ Q11(a)

Q10(b). Does the risk analysis and evaluation process include a qualitative or quantitative assessment, or both?

	(Tick one box only)
Only qualitative	☐1
Only quantitative	☐2
Both qualitative and quantitative	☐3

Q10(c). What time horizon is used for the assessment of risk levels and the probability of their occurrence, as well as for the correlation between the material risks?

Q10(d). Are the probability distributions of random variables determined using empirical or analytical methods? Explain briefly.

Q10(e). Does the risk evaluation process include stress tests and scenario analyses?

Risk treatment

Q11(a). Does the undertaking have in place appropriate risk treatment procedures? (Risk treatment refers to risk handling measures. Risk handling measures include concrete actions to avoid, limit, transfer and accept risks. Concrete actions would include for example increased controls to reduce the probability of risk occurrence or the increase of reinsurance cover to limit the amount of loss.)

	(Tick one box only)	
Yes	☐1	➔ Q11(b)
No	☐2	➔ Q12(a)

Q11(b). Briefly explain what concrete actions are taken by the undertaking in the risk treatment process to avoid, limit, transfer and accept risks.

Risk monitoring

Q12(a). Does the risk control process include regular monitoring of identified, analysed and assessed risks?

	(Tick one box only)	
Yes	☐1	➔ Q12(b)
No	☐2	➔ Q13(a)

Q12(b). In the monitoring process, do you carry out controls in respect of the following?

	Yes	No
Risk profile	☐1	☐2
Limits	☐1	☐2
Implementation of the risk strategy	☐1	☐2
Risk-bearing capacity	☐1	☐2
Risk-relevant methods and procedures	☐1	☐2
Risk handling	☐1	☐2

D. Internal company communication and risk culture

Q13(a). Does the undertaking have in place adequate internal communication of all material risks and an adequate risk culture within the undertaking which heightens the risk awareness of all employees involved with risks, creates sufficient risk transparency and promotes internal dialogues on risk management issues?

	(Tick one box only)	
Yes	☐1	➔ Q13(b)
No	☐2	➔ Q14(a)

Q13(b). Briefly explain what measures are taken to maintain an adequate risk culture and an adequate internal communication of all material risks within the undertaking.

E. <u>Written procedures</u>

Q14. Have any of the above-mentioned functions, procedures or processes been formally documented? (If formally documented, please specify for which areas.)

F. <u>Outsourcing of functions</u>

Q15(a). Does the undertaking currently outsource any of its functions or services?

	(Tick one box only)	
Yes	☐1	➔ Q14(b)
No	☐2	➔ Q15(a)

Q15(b). Which functions or services are currently outsourced?

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Q15(c). Does the undertaking have an outsourcing policy which includes considerations of the impact of the outsourcing on its business?

	(Tick one box only)
Yes	☐1
No	☐2

Q15(d). Has the company implemented reporting and monitoring arrangements in respect of the outsourced functions or services?

	(Tick one box only)
Yes	☐1
No	☐2

Q16(a). Does the undertaking intend to outsource any of the key functions under the provisions of the Level 1 text (i.e. the risk management function, the compliance function, internal audit function and actuarial function) with effect from implementation of Solvency II?

	Yes	No
Risk management function	☐1	☐2
Compliance function	☐1	☐2
Internal audit function	☐1	☐2
Actuarial function	☐1	☐2

Q16(b). Have you identified the service providers of the intended outsourced functions? (If already identified, please give name/s of service providers)

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Q16(c). ***Briefly explain what measures the undertaking intends to have in place to ensure that the outsourcing of the key functions does not lead to a material impairment of the quality of the undertaking's governance system and to an undue increase in operational risk. deterioration***

Signed by: ______________________________

(Director/Compliance Officer)*delete as appropriate