Achieving Effective Risk Management Practice under Solvency II
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Solvency II is largely about setting improved risk management standards for the insurance industry rather than simply being about rationalising capital requirements for insurers. Indeed, the principal objective of the Solvency II Directive (the “Directive”) is to instil a genuine culture of risk awareness in the day to day operations and working practices of insurance companies in order to strengthen policyholder protection in the long term. Recent emphasis has however shifted towards the quantitative assessment of risk and perhaps now that Pillar I has been examined in some detail and with the next Quantitative Impact Study (QIS) exercise due to be launched in the second half of 2010, more focus should be put on the significance of Pillar II and how the qualitative aspects of the Directive are to be implemented in practice. These qualitative principles represent the rationale of the Directive and are designed to encourage risk management practice that is pre-emptive and not reactive.

Solvency II requires insurers to integrate an effective risk management system into their organisational structure and decision making processes in order to enable them to identify, assess, manage, monitor and report the risks they are or might be exposed to. This system should take into account all material risks that may affect an insurer’s ability to meet its obligations to policyholders. This should include those risks included in the Solvency Capital Requirement (SCR) calculation under Pillar I as well as all other risks that may be materially relevant to the insurer’s business and which may not be covered under the SCR, including liquidity, strategic and reputational risk. This comprehensive identification and assessment of risks should include contingency-planning and ‘stress-tests’ in order to adequately prepare insurers for unexpected and adverse scenarios which may impact on their operations, solvency and risk profile.

As a fundamental part of its risk management system every insurer will be required to carry out its own risk and solvency assessment (ORSA) in order to identify whether the particular risk profile of an undertaking deviates from the assumptions underlying the SCR. The ORSA is intended to perform a dual function, firstly as a means for the insurer to obtain a true and practical understanding of the risks it is assuming and secondly as a tool for supervisory control. Supervisors will be given a range of remedial actions to correct any deficiencies in the insurer’s risk management system or even to impose additional capital requirements if they are dissatisfied with an insurer’s ORSA or the quality of its risk processes. The onus will be on the insurer to show that adequate processes are in place and continuous reassessment will be essential to cater for any changes in the insurer’s risk profile. The success of this approach to supervision will necessarily depend on the continual dialogue between the insurer and the supervisor, requiring both sides to work together constructively in developing effective systems and controls in accordance with the provisions of the Directive.

The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has to date published two Issues Papers in 2008 outlining their views on the Pillar II system of governance and ORSA. These papers provide a general overview of the risk management function required by the Directive and how it may be implemented but the lack of detailed guidance still leaves some uncertainty as to their application in practice. A significant consideration made by the Directive is the proportionality of systems and processes in relation to the “nature, scale and complexity” of the insurer’s operations and the risks inherent in its business. Each insurer must therefore be given the freedom to develop its own bespoke systems and controls that implement the principles outlined in the Directive according to its individual risk profile and to demonstrate their adequacy to their supervisor. Even so, further guidance is still essential in order to support and steer insurers towards Pillar II compliance.

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