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Supervisory Regulations and Policies Directorate

To the insurance and reinsurance undertakings whose head offices are located in Italy
TO THEIR PREMISES

To the Ultimate Italian parent companies
TO THEIR PREMISES

copy to the branches in Italy of insurance and reinsurance undertakings with head offices in a non European Economic Area country
TO THEIR PREMISES

RE: Results of the macroprudential analysis of the Reports on risk assessment and solvency (ORSA).

IVASS checks, using different tools, whether the single undertakings have adopted an adequate internal risk management system, also through the analysis of the reports on the "Own risk and solvency assessment" (ORSA Report) drawn up by each group or undertaking.

These microprudential analyses, which may be followed by an exchange of supervisory information, are supplemented by macroprudential comparative analyses: they allow to detect the presence on the market of risk concentration, common behaviours or use of similar methodologies and processes. The analyses conducted by IVASS on the ORSA Reports submitted in 2018 were focused on a broad sample of insurance undertakings and groups, representing about 75% of the insurance market in terms of premium income ([1]).

The guidelines provided are to be considered as assessment factors by all the insurance companies; these guidelines shall be implemented by the undertakings in compliance with the proportionality principle and calibrating the processes, methodologies and organization according to the actual riskiness and operational complexity which characterise them. In any case the ORSA Reports should adequately describe the contribution of the key functions to the process concerned and to the drafting and finalisation of the ORSA Report.

([1]) They cover 73% of life business and 76% of non-life business (data referred to YE 2017).

The examination of the 2018 ORSA Reports shows the significant progress made compared to the past year: many of the guidelines provided by IVASS in its letter to the market of 12 January 2018 have been implemented by the examined undertakings. However there are still key areas requiring improvement, as stated in the enclosed document.

IVASS hopes that the ORSA process and the Reports for 2018 take account of the guidelines indicated in the enclosed document, whose purpose is to point out to the undertakings IVASS' expectations for an ORSA process that is actually capable of correctly defining corporate strategies and the financial resources necessary to support them, apart from indicating the best market practices.

Best regards.

by delegation of the Joint Directorate

IVASS
ISTITUTO PER LA VIGILANZA SULLE ASSICURAZIONI

Annex

ORSA Reports for 2017

Progressive compliance of the ORSA reports with the regulatory provisions

As already noted in the previous year, the ORSA Reports submitted by the companies are gradually moving towards compliance with the provisions in the new ORSA regulation on the forward looking time horizon considered (3-5 years), the deadlines for transmitting the reports to IVASS, the reference date for the analysis and the use of the scheme of the supervisory report. The derogations envisaged by the regulatory provisions on the deadlines for transmitting reports and time horizon continue to be used in a very limited number of cases. However there are still areas needing improvement, as highlighted below, as regards compliance of the reports with the information listed in the scheme of the report indicated by IVASS([1]).

The ORSA process has been increasingly integrated into strategic choices and business management

The reports examined confirm that the ORSA process is being assimilated by business management, and has proved to be a useful tool to support the decision-making process (for ex. dividend distribution, capital management plan, product portfolio) and to update the strategic plan. In several cases the Report does not yet provide adequate explanation of the connection between the ORSA process, capital management and product development.

Improvements in the definition of the role of the actuarial function in the ORSA process

The role of the actuarial function within the ORSA process has been more clearly defined as regards the identification of the main technical risks and the definition of both the baseline and the adverse scenario assumptions. In some cases, the responsibilities of the actuarial function (when performing internal control activities) and of the actuarial department (when performing line activities) remain indistinct with specific regard to the definition of assumptions in forward-looking scenarios. This is part of the broader objective of better clarifying the role of the key functions within the ORSA process.

RAF is strengthening...

The *Risk Appetite Framework* (RAF) continues to strengthen and to show more widespread and greater risk awareness by the companies. The Reports show a gradual consolidation of the process for the analysis of current or potential exposures, including also risks not falling under the First Pillar. Greater accuracy was recorded in the description of the criteria, methodologies and assessment processes, as well as a clear definition of the solvency targets and the main risks.

....but the process for determining the solvency targets and tolerance thresholds needs to be improved

However, the process, the criteria and the methods applied to the identification of solvency target (or so-called risk appetite targets)need to be improved both when accurate values are identified and, most importantly, when ranges of change are assigned and the target values with related tolerance limits can be found therein. In this regard, a more detailed description of the methods and processes for the definition of targets and thresholds should be provided.

([1]) Annex 3 to IVASS Regulation no. 32/2016

The corrective actions to be activated when reaching the pre-determined thresholds must be clearly detailed

Many of the analysed groups have identified target thresholds in terms of capital and liquidity, with soft and hard fluctuation limits. The actions to be activated at the occurrence of some events and when approaching or reaching pre-determined alert thresholds or limits, need to be explained in greater detail. It is necessary to pay closer attention to the activation conditions, the escalation process and the times necessary for implementation. The determination of targets and tolerance thresholds must realistically consider the need to constantly have available capital surplus in excess of the required minimum which allows to effectively address sudden and unexpected unfavourable trends in the risk factors and related exposures.

Financial risks are perceived as more relevant than "technical" risks

The analyses have confirmed that, among the first pillar risks, those of a financial nature are prevalent: first of all, the spread risk followed by the interest rate risk and the equity risk.
Increasing emphasis is being placed on the monitoring and management of technical and operational risks, the latter especially in the case of companies and groups with larger investments in technologies, particularly digital ones.

Insufficient attention is paid to the risks not under the First Pillar

Too little attention is paid to the identification, measurement and mitigation of risks that are not under the First Pillar, although the exposure to some of them has grown due to market dynamics (e.g. the volatility of financial parameters has increased the likelihood of bearing losses in a case of forced divestment of considerable capital amounts). Undertakings must give the necessary attention to the activities aimed at the definition, identification and mitigation of risks that do not generate capital requirements, starting with liquidity risk and the risk of concentration of certain exposures. IVASS believes that strengthening the analysis of these types of risk represents a fundamental step toward the development of a more informed management and mitigation of risks as well as their interactions with other risk factors.

There is evidence of an increased use of stress testing and reverse stress testing techniques...

The largest groups have increased the use of stress testing (with single or multiple factors) by better specifying the assumptions underlying adverse scenarios of a macroeconomic nature and the assumptions related to the intrinsic dynamics of the insurance business (e.g. mass lapse, loss ratio). However, the description of the scenarios, the criteria adopted for shock calibration and the effects on solvency positions and on the assets and liabilities of the company must be improved. Explicit assessments must be included regarding the adequacy of the securities portfolio to face possible shocks.

...but the stress scenarios must be more severe

The use of reverse stress testing techniques is more widespread than it was last year, in particular on bond credit spread. Based on the most frequently used stress values (table 1) and the values actually assumed by some financial parameters in 2018, for some asset classes, there is a stronger need to increase the severity of the stress and worst case scenarios considered.

In order to increase the credibility of the assessment on the adequacy, also in a forward-looking perspective, of the financial resources supporting business strategies, it is necessary to forecast scenarios that include stress deriving from multiple risk factors.

Table 1

Stress values on main market risks

Risk Factors	Acenarios used[1]	Most frequent values
Government Bond spread	+75/+250 basis points	+100 basis points
Curve of risk free rate	-120/+300 basis points	+/-100 basis points
Value of equity securities	-20/-40 per cent	-25 per cent
Spread of private equity	+50/+150 basis points	+125 basis points
Value of real estate	-10/-25 per cent	-20 per cent

(1) the column indicates, for each risk factor, the extremes of the distribution of the values indicated in the ORSA reports of the undertakings.

It is necessary to strengthen the processes for estimating future variables through an extensive use of forecast back testing

The strategic and equity planning is supported and driven by assessments on the future profitability of the business. Forward-looking profitability estimates must be strengthened and more rigorously well-founded. The estimations of future exposures to single risks must be equally strengthened. Verifications between profitability assumptions and operating results actually recorded, as well as a comparison, for the single risks, between the values estimated in the previous ORSA report and those actually recorded (i.e. back testing), must be systematised in order to fine tune not only the estimation techniques but also the methodological robustness and the credibility of the entire ORSA process.

Finally, it is necessary to describe with greater detail and better coordination the way the assessment on the adequacy of the technical provisions is performed (point C.13 of annex 3 to Reg. no. 32); more emphasis must be given to the process and the outcomes of the ORSA self-assessment (point D.22, of annex 3 to the Reg. no. 32).