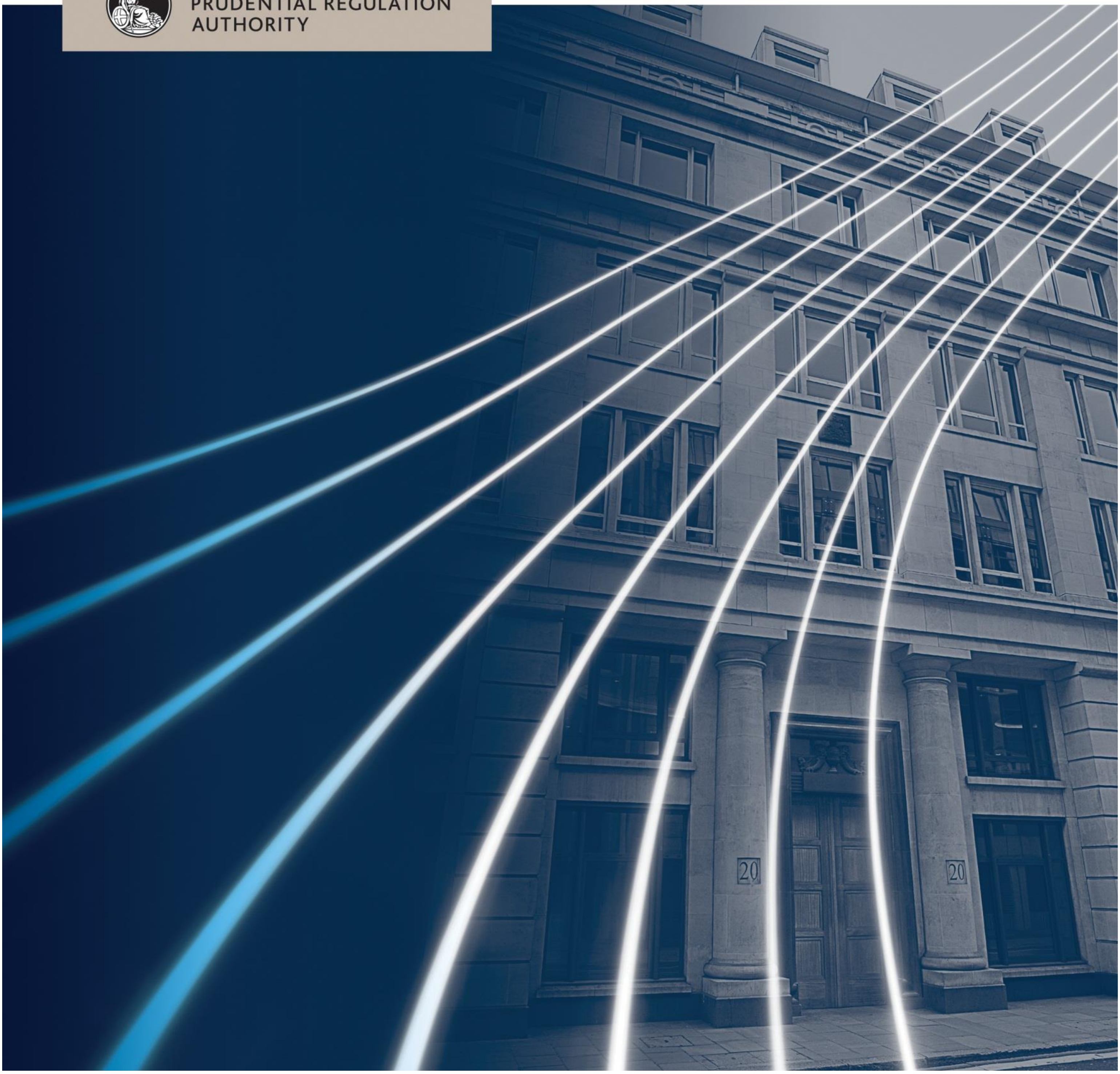
Policy Statement | PS33/16

Solvency II: consolidation of Directors’ letters

November 2016

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

Prudential Regulation Authority, registered office: 8 Lothbury, London EC2R 7HH.
Registered in England and Wales No: 07854923

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This policy statement provides feedback to the responses received for Consultation Paper (CP) 20/16, and contains the final supervisory statements.

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) policy statement (PS) provides feedback on the responses, and final supervisory statements for Consultation Paper (CP) 20/16, 'Solvency II: consolidation of Directors' letters', May 2016.[1]

1.2 This PS is relevant to all UK insurance firms within the scope of the Solvency II Directive ('the Directive')[2] and to Lloyd's.

1.3 The supervisory statements in the appendices to this PS set out the PRA's updated expectations for the following areas under the Directive:

- internal models – assessment, model change and the role of non-executive directors;
- longevity risk transfers;
- the own risk and solvency assessment (ORSA);
- reinsurance – counterparty credit risk;
- recognition of deferred tax;
- transitional measures on risk-free interest rates and technical provisions; and
- the treatment of pension scheme risk.

1.4 The Directors' letters[3] that form the basis of these supervisory statements will be archived.

2 Feedback to responses

2.1 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to consider representations that are made to it when consulting on its general policies and practices.[4]

2.2 The PRA received six responses to CP20/16. This chapter sets out the PRA's feedback to responses received for each of the new or amended SS proposed in CP20/16.

Internal models

2.3 While respondents generally welcomed the opportunity to comment on the material contained in the draft supervisory statement on the PRA's expectations for firms with internal models, they asked the PRA to provide more information on:

- the volatility adjustment (VA);
- the PRA's quantitative indicators for assessing internal model applications; and

1 See www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp2016.aspx.
2 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast).
3 These supervisory statements are based on material contained in Directors' letters, Executive Director's letters and feedback statements ('Directors' letters') issued between 1 April 2013 and 16 February 2016. See Appendix 8 for a mapping table for letters issued as PRA supervisory statements on 25 November 2016.
4 Sections 2N and 2L, FSMA.

- model changes.

The volatility adjustment

2.4 One respondent argued that firms using internal models should have the option of dynamically modelling the VA. They said that it is consistent with the Directive, reflects what would happen in the case of a shock, and is permitted in other Member States.

2.5 The PRA's view is that firms should not assume any change to the level of VA (expressed as the number of basis points in addition to the basic risk free curve) when calculating the solvency capital requirement (SCR). This view is consistent with the purpose of the VA, which is to provide countercyclical relief to firms' balance sheets. Anticipating this relief via a reduction in capital requirements would frustrate this purpose. Such an approach is consistent with the rule contained in the Solvency II Firms: Solvency Capital Requirement – General Provisions 3.6 Part of the Rulebook (which transposes Article 77d(6) of the Solvency II Directive).

2.6 Firms using the standard formula to calculate their SCR are not allowed to assume any change in the level of the VA.

2.7 If EIOPA should decide to issue guidance on how to treat the VA in calculating the SCR using an internal model in future, the PRA would consider that carefully and would provide an update to the UK industry on its views, as necessary.

The PRA's quantitative indicators for assessing internal model applications

2.8 In the draft supervisory statement on internal models, the PRA provided some detail on the use and application of the PRA's quantitative indicators (QI) to generate discussion, increase transparency, and to help firms with their internal model applications.

2.9 There were many questions and helpful comments from respondents on the PRA's use and approach to the setting of QI. The PRA has reflected on the points raised by respondents. While it recognises the rationale for the points made, it remains content with its approach, both in terms of the setting of the QI and the level of disclosure. However, the PRA also recognises that with evolving thinking and technical advances over time, risk models and these QI may change. Since approaches and issues that may be subject to such change are not usually included in supervisory statements, these chapters will not be included in the final version of the SS.

Model changes

2.10 One respondent questioned whether minor changes could be accumulated on a net basis rather than an absolute basis, if justification were provided. A respondent also noted the difference between CP19/16 'Solvency II: Changes to internal models used by UK insurance firms'[1] and CP20/16, in that from the two documents it was unclear if a combination of minor model changes which led to a major model change then resulted in the accumulation of minor model changes to be reset, or whether it was for the PRA to decide when this resetting took place.

2.11 The PRA has subsequently issued another supervisory statement, SS12/16 'Solvency II: Changes to internal models used by UK insurance firms'[2] which addresses these and other aspects of changes to internal models. Additionally, the PRA has adjusted the text in the supervisory statement on internal models included in this PS to reflect this.

1 May 2016; www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp1916.aspx.
2 September 2016; www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss1216.aspx.

Longevity risk transfers

2.12 Some respondents queried the PRA's text on the following issues for the draft supervisory statement:

- that a small number of counterparties (or connected counterparties) for hedging or transferring longevity risk automatically led to an increase in counterparty risk;

- that additional measures may be needed when these types of transactions are undertaken:

- they did not think that the use of collateral was a decision for the PRA, but rather one for firms and were concerned that the PRA may be considering expecting firms to use termination and recapture clauses in undertaking these transactions; and

- they were concerned that this statement could be implying that a firm's use of longevity risk transfers would render the standard formula invalid.

2.13 The PRA's expectation on the use and management of longevity risk transfers seeks to ensure that firms are considering all the aspects of risk assessment and measurement. For the PRA's response on the number of counterparties see paragraph 2.16 below on the feedback to the draft supervisory statement 'Solvency II: reinsurance – counterparty credit risk'.

2.14 The PRA also considers that the supervisory statement is phrased in a way that allows for various approaches to the structuring of longevity solutions, and is not expecting one particular method or approach. While the choice of whether and how a transaction is collateralised is a decision for a firm, the PRA notes that in order to make this decision, the risks and benefits must be assessed and the capital implications firmly understood.

2.15 In terms of the ongoing appropriateness of the standard formula, the PRA will consider this with firms on a case-by-case basis.

Reinsurance – counterparty credit risk

2.16 Respondents generally welcomed the consultation on reinsurance – counterparty credit risk. However, there were some raised concerns about the emphasis on the number of counterparties in measuring the concentration risk for counterparty credit risk and the mention of credit risk mitigation techniques including the use of collateral in addressing build-up of concentration risks. Firms also thought that credit risk mitigation should be a commercial decision. Finally, firms were concerned that the text appeared to suggest that reinsurance would invalidate the use of the standard formula.

2.17 The draft supervisory statement focussed on major arrangements, often found in larger firms. The PRA is aware that the practicalities and economics of placing reinsurance for smaller firms can be different, as can be the wider potential impacts on markets and policyholders, should such arrangements fail. The PRA has updated its expectations in the final supervisory statement to make clearer that, while all firms are expected to manage and, as necessary, mitigate the effects of concentration of credit risk, for small firms, the scale of their firm's operations can be relevant to the assessment of risks.

2.18 The PRA considers that the standard formula does not always reflect sufficiently the risks within some reinsurance arrangements. It is for the firm to assess whether or not this is material in the context of its overall assessment of standard formula appropriateness, and to demonstrate why the standard formula remains appropriate to its risk profile where this is potentially the case.

2.19 One firm also was concerned that the PRA was seeking to introduce termination or recapture clauses linked to the SCR as a means of managing counterparty concentration risk. The PRA is not introducing any new expectations regarding these clauses, and the statement reflects the approach some firms use in managing this risk, while also recognising that solutions can be tailored uniquely to a firm's business.

ORSA

2.20 One respondent felt that the supervisory statement seemed to view the ORSA as a supervisory report, rather than a tool for firms to measure, manage and monitor their overall risk. It was also noted that some ORSA decisions are difficult and in some cases unnecessarily burdensome to log as there are many aspects to some of these decisions, and the solutions do not always follow a linear process.

2.21 In response to these points, the PRA is of the view that while the ORSA is primarily a process for firms to understand and manage their business, risks, and capital appropriately, the ORSA also must be reported to supervisory authorities, and the PRA's view is that this is appropriately reflected in the supervisory statement and so the supervisory statement has not been changed. Firms should consider their risks and capital based on their own perspective, as well as on a regulatory basis. The examples given in the supervisory statement reflect the PRA's view of good practice seen across the industry. The ORSA report should provide evidence of the firm's own ORSA processes, which includes an accurate record of the decisions taken by the board at any given time. The level of detail included should, as set out in the EIOPA Guidelines, enable a qualified third party to evaluate the assessments.

Other SSs

2.22 There were no responses to the consultation on the supervisory statements for recognition of deferred tax, transitional measures on risk-free interest rates, and technical provisions, or the treatment of pension scheme risk. The final supervisory statements have been published, with changes only made to correct minor errors or formatting issues. Each of these statements has an appendix which outlines the changes in more detail.

Appendices

1	**SS17/16 'Solvency II: internal models – assessment, model change and the role of non-executive directors' available at www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss1716.aspx**
2	**SS18/16 'Solvency II: longevity risk transfers' available at www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss1816.aspx**
3	**SS19/16 'Solvency II: ORSA' available at www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss1916.aspx**
4	**SS20/16 'Solvency II: reinsurance – counterparty default risk' available at www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss2016.aspx**
5	**SS2/14 UPDATE 'Solvency II: recognition of deferred tax' available at www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss214update.aspx**
6	**SS17/15 UPDATE 'Solvency II: transitional measures on risk-free interest rates and technical provisions' available at www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss1715update.aspx**
7	**SS5/15 UPDATE 'Solvency II: the treatment of pension scheme risk' available at www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss515update.aspx**
8	**Mapping table for letters issued as PRA supervisory statements**

Appendix 8: Mapping table for letters issued as PRA supervisory statements[1]

Supervisory statement	Date of letters
SS17/16 – Solvency II: internal models - assessment, model change and the role of non-executive directors	19 December 2014, 9 March 2015, 13 March 2015, 16 March 2015, 7 May 2015, 22 May 2015, 5 June 2015 and 15 January 2016.
SS18/16 – Solvency II: longevity risk transfers	9 February 2016.
SS19/16 – Solvency II: ORSA	15 June 2015.
SS20/16 – Solvency II: reinsurance - counterparty credit risk	6 November 2015 and 4 December 2015.
SS2/14 UPDATE – Solvency II: recognition of deferred tax	13 March 2015.
SS17/15 UPDATE – Solvency II: transitional measures on risk-free interest rates and technical provisions	16 September 2015 and 6 November 2015.
SS5/15 UPDATE – Solvency II: the treatment of pension scheme risk	14 July 2015.

To be helpful to readers, the table below shows where each of the items referenced in the table is archived on the Bank's website.

Date	Title of letter	URL
9 February 2016	Insurance Directors' update letter	www.bankofengland.co.uk/pra/Documents/about/insdirectorsletter09022016.pdf
15 January 2016	Reflections on the 2015 Solvency II internal model approval process	www.bankofengland.co.uk/pra/Documents/solvency2/edletter15jan2016.pdf
4 December 2015	Continued soft market conditions in the UK general insurance sector	www.bankofengland.co.uk/pra/Documents/about/insuranceletter041215.pdf
6 November 2015	PRA Solvency II Directors' update letter	www.bankofengland.co.uk/pra/Documents/solvency2/insdirectorsletter11nov2015.pdf
16 September 2015	Directors' letter 'Longevity risk transfers'	www.bankofengland.co.uk/pra/Documents/about/directorsletter16sep2015.pdf
14 July 2015	PRA Solvency II: Insurance Directors' update letter	www.bankofengland.co.uk/pra/Documents/solvency2/directorsletterjuly2015.pdf
15 June 2015	Solvency II ORSA feedback	www.bankofengland.co.uk/pra/Documents/solvency2/s2orsafeedback15June2015.pdf
5 June 2015	Volatility adjustment in the modelling of market and credit risk stresses	www.bankofengland.co.uk/pra/Documents/solvency2/solvency2vaclarificationjune2015.pdf
22 May 2015	Solvency II: Insurance Directors' update letter	www.bankofengland.co.uk/pra/Documents/solvency2/insurancedirectorsupdateletter22May2015.pdf
7 May 2015	Internal model change policy	www.bankofengland.co.uk/pra/Documents/solvency2/imchangepolicymay2015.pdf
16 March 2015	Observations of internal model validation	www.bankofengland.co.uk/pra/Documents/solvency2/intmodvalidmar2015.pdf
13 March 2015	PRA Solvency II Insurance Directors' update letter	www.bankofengland.co.uk/pra/Documents/solvency2/insurancedirectorsupdatemarch2015.pdf
9 March 2015	Solvency II internal model and matching adjustment update	www.bankofengland.co.uk/pra/Documents/solvency2/intmodmaupdatemar2015.pdf
19 December 2014	PRA Solvency II Insurance Directors' update	www.bankofengland.co.uk/pra/Documents/solvency2/insurancedirectorsupdatedecember2014.pdf

1 CP38/16, 'Solvency II: group supervision' was issued in November 2016 and a separate consultation on the matching adjustment is forthcoming.