Institute and Faculty of Actuaries

6 September 2023

PRA CP12/23 - Review of Solvency II: Adapting to the UK insurance market

IFoA Response

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

Key points

The IFoA welcomes the opportunity to respond to the PRA's consultation on the Review of Solvency II (SII). We recognise that the PRA's proposals are wide-ranging and represent a significant milestone in adapting SII to better reflect the particular features of the UK insurance sector. We have considered the PRA's proposals from an independent, public interest perspective.

We are broadly supportive of the range of PRA proposals to adapt SII to the UK insurance sector, and our main points relate to the proposals on the TMTP, internal models, Capital Add-Ons and reporting/ disclosure.

We welcome the PRA's proposals to simplify the calculation of the TMTP, including the proposed new default approach based on the results produced under SII (rather than under the former Solvency I/ ICAS regime). We share the PRA's view that the proposed approach balances risk sensitivity with pragmatism/ methodology efficiency.

In relation to TMTP amortisation, the consultation paper confirms that a firm's TMTP is subject to a consistent annual deduction and is not intended to give rise to a 'double run-off' effect. We note this point is currently confirmed within SS6/16, which is due to be deleted. We therefore suggest that some clarification on double run-off be retained post SS6/16.

The IFoA supports the PRA's proposed reforms to the internal model framework including the streamlining of tests and standards, and the introduction of a range of internal model approval safeguards, which could potentially support a pragmatic approach to (internal) modelling. This includes the use of Capital Add-Ons. In this respect, we believe that open and constructive dialogue between the PRA and firms is key. Such dialogue should include where relevant agreement to the use of the Capital Add-On, clarity on its purpose, agreement on the methodology and basis of calculation and clarity on the steps a firm needs to take to remove it.

One concern we have with Capital Add-Ons is the risk that they become over-used. We note that over-reliance on Capital Add-Ons could also potentially lead to a general weakening of modelling standards, which would not be in the public interest.

We support the PRA's aims to improve the efficiency and relevance of SII reporting and disclosure. The PRA's proposals have the potential to make SII reporting in the UK more proportionate and fit-for-purpose. We believe this can be done without compromising the safety and soundness of firms, or of policyholder protection.

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PRA CP12/23 - Review of Solvency II: Adapting to the UK insurance market

IFoA Response

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's Consultation Paper CP12/23 Review of Solvency II: Adapting to the UK Insurance Market. We recognise that the PRA's proposals within the CP are wide-ranging in scope and represent a significant milestone in adapting Solvency II (SII) to better reflect the particular features of the UK insurance sector.

2. In developing our consultation response, we have drawn upon input from a range of members working in both life and general insurance, either for insurers themselves or for consultancies.

3. As with any IFoA response, we have considered the PRA's proposals from an independent, public interest perspective. In doing so we have considered the potential implications on safety and soundness, maintaining policyholder protection and advancing the PRA's new secondary competitiveness and growth objective.

4. Given the above, we believe that the IFoA has an important role to play in the debate on the future evolution of SII in the UK. We would therefore be delighted to discuss our response with the PRA in due course.

5. In our detailed comments below, where relevant we revisit a range of points made in our earlier responses to HMT in their *Review of SII Call for Evidence* (February 2021) and *Review of SII* (July 2022). We reiterate our support for HMT's underpinning objectives in their SII review, including the need for a prudential regulatory regime which fosters innovation and international competitiveness, appropriate policyholder protection/ soundness of firms, and facilitates long-term infrastructure and 'green' investment. We also support HMT's related aim of reducing the SII administrative and reporting burden. We have also borne these objectives in mind in drafting this response.

6. We are broadly supportive of the range of PRA proposals to adapt SII to the UK insurance sector, as set out in CP12/23 and associated appendices. For example, the proposal for a mobilisation stage for new insurers could help new entrants to the insurance market, facilitating greater competition, which is the public interest.

7. The bulk of our response to the CP focusses on the following proposals where we have a range of specific points to raise:

    - Transitional Measures on Technical Provisions (TMTP);
    - Internal Models;
    - Capital Add-Ons; and
    - Reporting and Disclosure.

8. For completeness, a number of other/ minor points are covered at the end of our response.

TMTP

9. The IFoA welcomes the PRA’s proposals to simplify the calculation of the TMTP including the proposal to introduce a new default approach based on the results produced under SII (rather than under the former Solvency I/ ICAS regime). We share the PRA’s view that the proposed approach balances risk sensitivity with pragmatism/ methodology efficiency.

10. In our earlier responses to HMT, we noted that the calculation and maintenance of the TMTP is highly complex, and that its objective could continue to be met through simpler methods. In addition, we suggested that pragmatic simplifications to firms’ TMTP calculations could remove the areas of associated complexity. This could potentially reduce balance sheet volatility making firms’ capital positions easier to understand and supervise. Hence we support the PRA’s proposed default approach. We expect that where firms are able to adopt this simplification there may also be potential efficiencies where Solvency I/ ICAS models and processes no longer need to be maintained.

11. The IFoA agrees that the use of SII results (through the proposed default method) may improve consistency by increasing the standardisation of methodology between firms. Our understanding is that there is currently significant diversity in the approaches to TMTP calculation adopted by UK firms. We also agree with the PRA’s assessment that the proposed TMTP simplifications can be achieved without adversely impacting policyholder protection. Given these points, we believe the PRA’s TMTP proposals are in the public interest.

12. The option for firms, subject to successful application, to maintain their use of the current TMTP calculation - the ‘legacy approach’ - may be helpful to affected firms in avoiding potential unintended consequences of the proposed default approach.

13. The IFoA also supports the proposal to remove the Financial Resources Requirement (FRR) test. Our view is that the FRR test had become onerous to perform. Furthermore, the comparison with Solvency I/ ICAS results had become outdated and less relevant. We note similar points are made within the CP12/23. The risk margin has a bearing on the FRR calculation and for consistency we suggest that the FRR removal coincides with the effective date of risk margin reform.

14. In relation to TMTP amortisation, CP12/23 explains that the proposed amortisation approach is intended to ensure that a firm’s TMTP is subject to a consistent annual deduction and is not intended to give rise to a ‘double run-off’ effect. The IFoA had referred to this doubling of the TMTP run-off profile ‘error’ in our HMT SII Call for Evidence. We note that Supervisory Statement SS6/16 currently clarifies this double run-off point (paragraph 4.20), although we note further that SS6/16 is due to be deleted from Year End 2024. We therefore suggest that some clarification on double run-off be retained post SS6/16.

Internal Models

15. The IFoA broadly welcomes the PRA’s proposed reforms to the internal model framework including the streamlining of tests and standards, and the introduction of a range of internal model approval safeguards. We agree that the PRA’s proposals do not represent a reduction in internal modelling standards. We also share the PRA’s view that its proposals have the potential to increase the efficiency of the internal model approval and change process. In practice however, the extent of any efficiency gains may depend on the circumstances of individual firms.

16. In our earlier responses to HMT, we noted that the (current) internal model approval and change processes and associated documentation requirements are onerous. We suggested that they could be more proportionate by taking a more principles-based approach, backed up by a range of relevant

safeguards. In our view these points are reflected in the PRA's internal model proposals which are welcome. We support a more flexible internal model framework, with less prescription.

17. CP12/23 proposes that the current internal model approval process would be replaced by an internal model permission approach; firms with current approved internal models would not need to apply for permission, which is welcome. We note that where relevant firms would have a two-year window to update their internal model in respect of any Model Limitation Adjustments (MLAs). This two-year window is helpful in itself, but we are unclear on whether the PRA's envisaged MLA scope could be wider than that for typical 'out of model adjustments' currently made by firms.

18. The CP explains further that the PRA expects MLAs to be positive, resulting in an increase to the Solvency Capital Requirement (SCR). It goes on to suggest that a negative MLA resulting in a reduction to the SCR would represent a lowering of model standards. We do not accept this necessarily follows: 'an out of model adjustment' could quite feasibly be negative.

19. In relation to internal model validation, we note the PRA proposal to remove the need for a profit/ loss attribution analysis and replace it with an analysis of change. In principle the use of analysis of change in SCR makes sense as a validation tool; we understand that typically such analysis is already undertaken. In addition, some firms also consider analysis of Own Funds as a further control check.

20. In respect of the corresponding Form AoC.01, we suggest that a pragmatic approach is taken to the relevant documentation requirements to avoid this disclosure becoming a new and significant regulatory overhead. Materiality considerations will be important here, although we note that there could be instances where several changes are not regarded as material on an individual basis, but which add up to a material amount in aggregate.

21. On a more minor point on Form AoC.01, the draft suggests that each material change is to be included with a 'balancing item' automatically calculated. There is no guidance on what is deemed to be a material change and how large the balancing item can be. It would be useful to provide an upper bound on the size of the balancing item as a percentage of the change.

22. The proposed replacement of the profit/ loss attribution analysis is reasonable, but we note that the expectation had been that this would have had increased value when produced over time, and so may have become more useful in future. A further benefit of the profit/ loss attribution analysis was potentially identifying experience that arose which was not modelled. Both insurers and the PRA will need to ensure that such analysis is still captured elsewhere.

23. Consistent with our earlier responses to HMT (and mentioned above), the IFoA welcomes the PRA's proposal to depart from the current 'binary' nature of internal model approvals through the use of modelling safeguards. We note both proposed safeguards:

    - a Residual Model Limitation (RML) Capital Add-On; and
    - a (qualitative) requirement safeguard such that the internal model remained appropriate to the firm's risk profile.

24. These safeguards could potentially support a pragmatic approach to (internal) modelling. Given that the PRA aims to extend internal model permission to models considered sound but not wholly compliant (and rejected for approval under the status quo), we agree that the PRA's proposals here should widen the use of internal models, which is in the public interest.

25. However, whilst we recognise that an RML Capital Add-On could be a pragmatic internal model safeguard, it will be important to ensure that some Capital Add-Ons do not become ‘sticky’, over-used and difficult to remove.

26. Another concern would be existing ‘approved model’ insurers being discouraged from making major model changes if they could become subject to (RML) Capital Add-Ons. The PRA should consider consistency between insurers where one has an already approved internal model (without Capital Add-On) and another insurer applying for new internal model permission under the new regime with a potential RML Capital Add-On.

We discuss Capital Add-Ons further in the next section.

27. Our understanding from Appendix 5 is that the PRA’s timescale for the outcome of initial internal model applications remains unchanged at 6 months. The current approval timelines (including pre-application, initial application and model change) are lengthy, and further clarity on the various process timelines would be helpful.

28. CP12/23 explains that internal model is taken to include both partial internal models and full internal models. It would be useful if the PRA (or HMT) were to confirm whether it intended making any changes to the partial internal model-specific elements (e.g. the integration techniques allowed).

Capital Add-Ons

29. In our earlier responses to HMT we suggested the application of Capital Add-Ons could benefit from:

    - the need for agreement to the use of the Add-On between the firm and the PRA;
    - the reason for the Add-On being should be clearly articulated;
    - the methodology and basis for the calculation being clearly defined and agreed between the firm and the PRA; and
    - clarity on the steps a firm has to take to remove the Add-On, with the steps being well-defined and achievable.

30. Our view is that these requirements of a Capital Add-On approach remain important if it is to be transparent and fair to firms. We also believe that open, constructive dialogue between the PRA and firms on the application and pathway to their subsequent removal is key.

31. Under the current SII framework Capital Add-Ons could be regarded as a last resort. In our view it is important that they are used sparingly in any revised SII framework. Over-reliance on Capital Add-Ons could also potentially lead to a general weakening of modelling standards, which would not be in the public interest.

32. In the specific context of an internal model application, we presume where relevant that a Modelling Limitation Adjustment (discussed above) would be considered initially, with recourse to a RML Capital Add-On as an alternative only where necessary.

33. A new alternative method for calculating a Capital Add-On for internal model significant risk profile deviation in *exceptional* circumstances is proposed. Given the subsequent flexibility this proposed power would confer upon the PRA, greater clarity on what would be regarded as exceptional circumstances would be helpful.

34. Although CP12/23 sets out a basis for the new calculation of the internal model significant risk profile deviation Capital Add-On, we are not convinced the new approach will necessarily be appropriate. For firms with business where the Standard Formula SCR calculation is a poor fit to the corresponding risk profile, then setting a Capital Add-On derived from the difference between the internal model SCR and a potentially spurious Standard Formula SCR may be erroneous.

35. The Draft of Appendix 13 *Solvency II: Capital Add-Ons* sets out the proposed circumstances for setting Capital Add-Ons. We note that as well as the internal model risk profile, this includes significant deviations in relation to the assumptions underlying the relevant risk-free rates and TMTP. With respect to risk free rates and the TMTP, we believe it would be misleading to refer to these as *Capital* Add-Ons. More importantly, we think the PRA should give more clarity on when such (non SCR) Add-Ons could be applicable.

Reporting and Disclosure

36. We support the PRA's aims to improve the efficiency and relevance of SII reporting and disclosure. The PRA's proposals have the potential to make SII reporting in the UK more proportionate and fit-for-purpose. We believe this can be done without compromising the safety and soundness of firms, or of policyholder protection. Streamlining of reporting should also have wider benefits, including greater efficiency in reporting production (by firms) and analysis (by industry commentators).

37. We note that the PRA proposals include removal of, amendment to, and addition of new reporting requirements. The net impact on the overall burden of reporting will vary from firm to firm according to their circumstances. It is plausible that a net reduction in reporting may be more likely for standard formula firms. For larger firms where the reduction in the net reporting burden is limited (or negated), any resulting costs may eventually impact consumers.

38. The proposed deletion of the Regulatory Supervisory Report (RSR) seems sensible, although we presume that the PRA anticipate accessing information they require, and currently within a firm's RSR, from other sources.

Other/ Minor Points

39. We note the proposal to remove the requirement for third country branches to calculate and report branch capital requirements. We do not have any concerns with this proposal from our own perspective. Our understanding however is that the Bank of England may be planning to require foreign banks, operating as branches in the UK, to convert those branches into subsidiaries. The PRA's proposals if implemented may then give rise to a potential inconsistency in treatment of insurance and banking branches (although we accept that may be intentional).

40. CP12/23 explains that the proposals on third country branches do not apply to Swiss general insurers, but it does not outline how such insurers are to be treated.

41. It would be useful for the PRA to confirm that the external audit requirement changes are all captured in Appendix 22 (which only suggests changes to audit requirements for Form S25.X).

42. CP12/23 makes reference to the subsequent consultation planned for September 2023 in relation to proposals for life insurers relating to investment flexibility and the matching adjustment (MA). Although not within the scope of CP12/23, and accepting that the subsequent consultation proposals may be at an advance stage of drafting, we note that the MA is also relevant to some non-life insurers, in particular those with Periodical Payment Order (PPO) liabilities.

43. In a similar vein, CP12/23 also makes reference to reform of the SII risk margin. We note that HMT published drafts of the Statutory Instruments required to support reform of the risk margin, and as such risk margin reform is not subject to consultation within CP12/23. However, the final Statutory Instrument refers to ‘life insurance obligations’ which is a clearly defined SII term, and only includes settled PPOs (and so not potential PPOs). This wording is not entirely helpful and creates some confusion around PPO treatment. If all PPO liabilities including potential PPOs are intended to be within scope, then the Statutory Instrument should make this clear. We do however recognise that this may be a point for HMT as well as the PRA to consider.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk) in the first instance.

Yours Sincerely,

Matt Saker

President, Institute and Faculty of Actuaries