BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

PRA Solvency II update

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Agenda

1. 2015 Update
2. What is standard formula?
3. Internal models
4. Matching adjustment
5. ORSA
6. System of governance
7. Regulatory reporting

1. 2015 Update

- Policy statement 2/15 Solvency II: A new regime for insurers
- Consultation papers:
  - Consistency of UK generally accepted accounting principles with the Solvency II Directive (CP16/15)
  - Treatment of sovereign debt in internal models (CP14/15)
  - Supervisory approval for the volatility adjustment (CP11/15)
  - Transitional measures and the treatment of participations (CP3/15)
  - Applying EIOPA's Set 1 Guidelines to PRA-authorised firms (SS22/15)
- Directors' letters to firms
- Non-executive directors briefing for firms considering internal model for 01 Jan 2016
- In conversation with the PRA - ABI webcast with Paul Fisher

Timeline

Q4 2014 | Q1 2015 | Q2 2015 | Q3 2015 | Q4 2015 | 2016

**Transposition
31 March 2015**

**Implementation
1 January 2016**

Firms start to apply for approvals including IM, USPs, Exemptions etc.

SII approvals - PRA formal review period

Firm and PRA continuous evaluation of IM and standard formula appropriateness

2015 data request

PRA completed assessments of priority SF firms

PRA assess appropriateness of all other standard formula firms

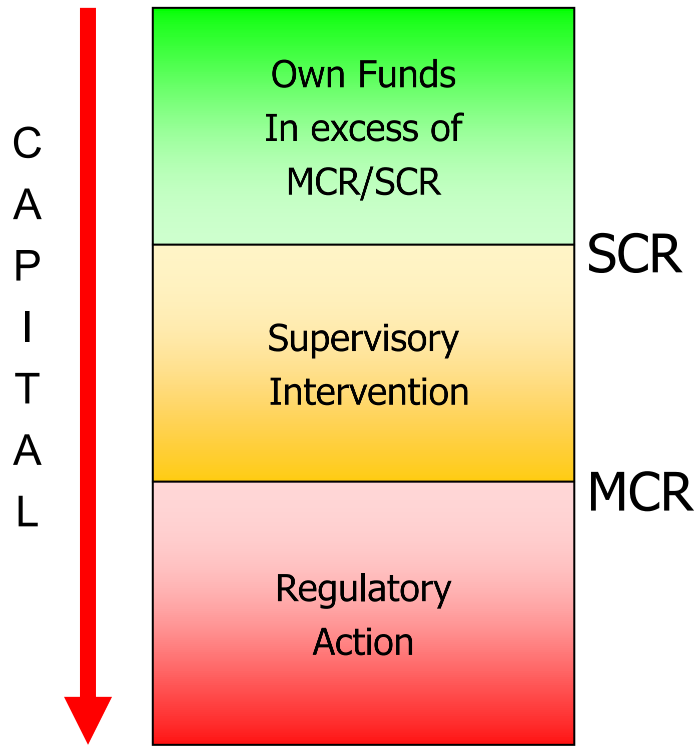
Completed 2014 ORSA reviews

2015 ORSA reviews and 2014 feedback

PRA decision/activity

Firm activity

Pillar 1 – ladder of supervisory intervention



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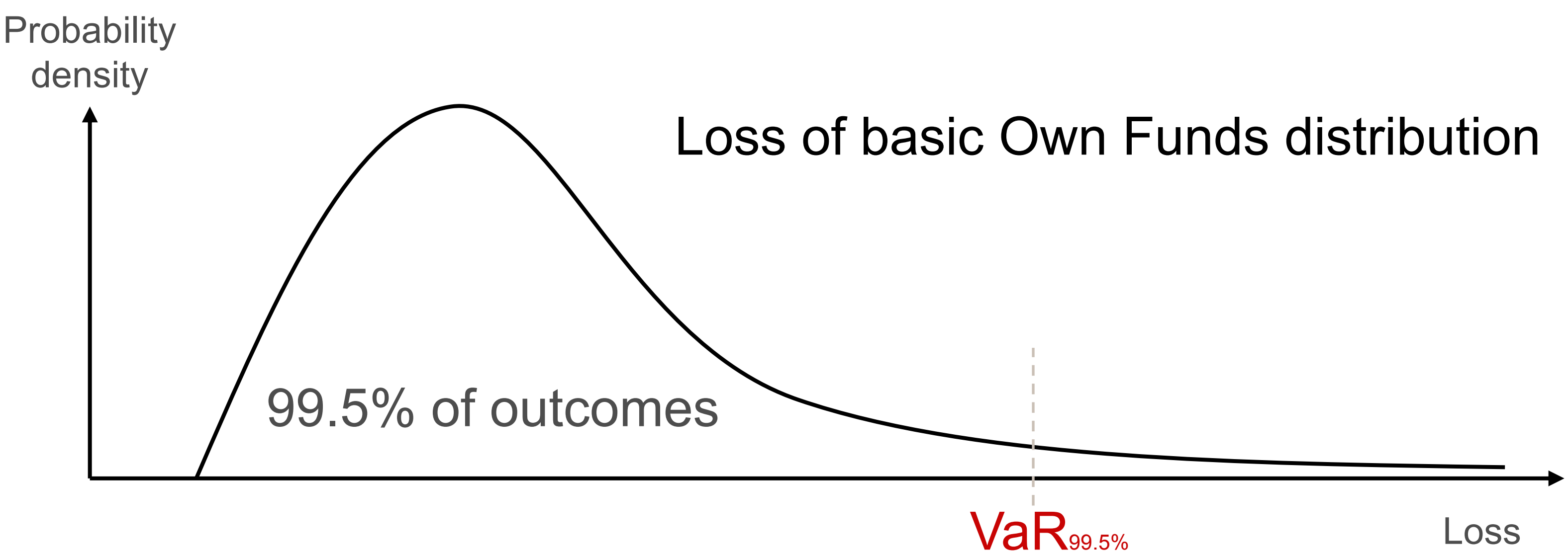
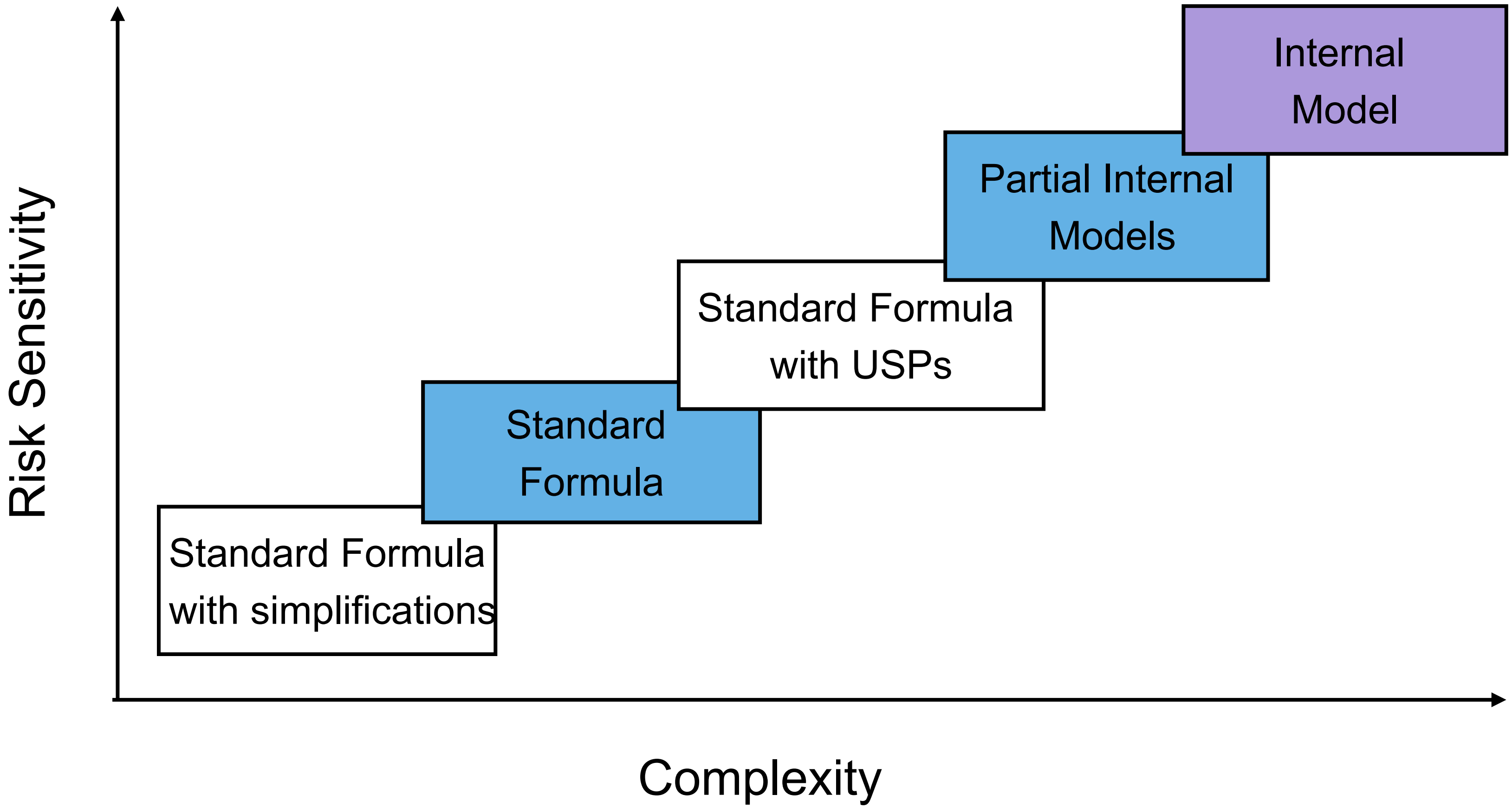
Pillar 1 – what is the SCR?

- SCR: 99.5% Value at Risk of basic Own Funds over 1 year

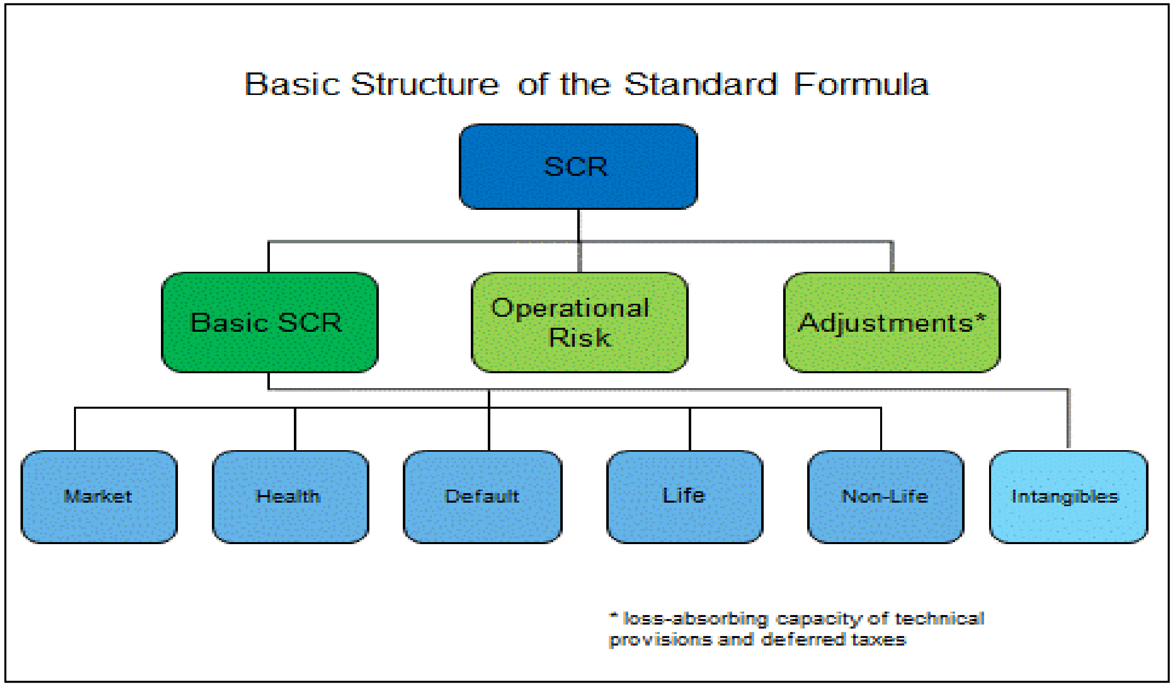


Pillar 1 – calculating the SCR



2. What is the standard formula?

- A one size fits all approach
- Less demanding than the Internal Model framework
- However, less flexible



Standard formula appropriateness

PRA approach to assessing SF SCR appropriateness

- Standard formula should fit a significant proportion of UK firms
- The PRA has completed a review of the standard formula appropriateness of 20 firms in Q1 2015
- High-level review of all other firms throughout 2015
- Review will be based on quantitative deviations and qualitative information including the ORSA
- Proportionate approach, noting idiosyncratic nature of some firms
- Responsibility rests with the Board to challenge standard formula appropriateness
- Responsibility of the firm to identify areas where the firm materially deviates from the standard formula assumptions
- Solvency II should be implemented in a proportionate manner, in accordance with the principle set out in the Directive

Standard formula appropriateness for life insurers

Some examples of potential indicators of inappropriateness:

Risk areas that may form part of life insurers standard formula reviews

Longevity:

Firms with particular sector focus where their portfolio might be considered to have unusual concentrations e.g. deferred, enhanced or impaired annuities

Equity:

Firms pursuing an active investment strategy or with a concentrated equity portfolio

Credit:

Firms hold a variety of credit risky assets that may not be well represented by the average portfolio of corporate bonds assumed within the Standard Formula

Operational:

Firms with significant outsourcing arrangements and / or a range of legacy systems

Pension risk

Standard formula appropriateness for general insurers

Potential indicators of inappropriateness:

Risk areas that may form part of a general insurer's standard formula reviews

Non-Life underwriting risk:

Where deviations from underlying assumptions are significant

PPOs:

Should be modelled in the life underwriting sub-module (longevity risk). Long term solution may be to consider use of partial internal model – where proportionate to do so

Cat Risk:

Firms with non-standard portfolios with a large element of non-European economic area (EEA) catastrophe risk or with large deductibles or complex outwards reinsurance programmes

Credit Risk:

Reinsurance counterparty risk

Pension Risk

Options where the standard formula does not capture risk profile

Regular dialogue

- Firm Dialogue and supervisory review
- ORSA review and post-ORSA action plan

Firm initiated action

- Undertaking Specific Parameters
- Partial internal model

PRA initiated action

- Capital add-on, which may lead to:
- Partial internal model
- Full internal model

3. Internal models – the PRA approach

- No policy preference for firms to develop internal models
- Linked to firms' and PRA's view on standard formula appropriateness
- All models have limitations and need to be used with care
- Solvency II sets a high bar for model approval and sets rigorous standards for technical modelling and supporting governance
- Boards of IM firms are responsible for ensuring that models are fit for purpose, meet the tests and standards, and that the output is credible for use in the business and for regulatory purposes

Lessons from the pre-application phase (1)

- **Modelling weaknesses:**
  - Key judgements and assumptions not always highlighted or justified
  - Documentation insufficient to explain the approaches adopted
  - Optimistic assumptions which do not match prior experience
  - Use of data which excludes historical events
  - Use of external models without consideration of appropriateness
  - Models ignoring some key risks faced by firms
  - Overly-optimistic assumptions on diversification in extreme scenarios

Lessons from the pre-application phase (2)

Supporting infrastructure and governance:

Use test

- Important to demonstrate belief in the model – but not “blind faith”

Board understanding

- Key assumptions, strengths, weaknesses, limitations, sensitivities
- Not technical detail

Validation

- Should be independent – this can be internal or external
- Should be seen as a key tool to help give Boards insight into the model
- Boards should be involved in directing validation onto key issues, not getting lost in the detail
- Boards need to own the validation design, ensure its output is in a format they can engage with, and track key issues raised

4. Matching adjustment

- PRA expected some firms/trade bodies to raise practical concerns/issues in response to its letters/communications
- PRA expect to reflect on these to assess whether to revise any of the agreed policy lines
- Firms should liaise with their supervisory contact for any questions on MA

5. Own risk and solvency assessment (ORSA)

- During the preparatory phase – the PRA will review at least one ORSA from all Category 1-4 firms.
  - The PRA have reviewed 80% of Cat 1-3 firms ORSA reports
  - The PRA is intending to provide industry feedback in 2015-Q2
- Key Messages:
  - The ORSA is not a compliance exercise resulting in a report for the PRA
  - It should not be a ‘good news’ report but should highlight key risks and allocate mitigation to named individuals
  - The ORSA should be holistic, bringing together strategy, stress testing, risk management and solvency into one cohesive framework
  - The key to a ‘good’ ORSA is linking these areas together successfully

PRA findings from ORSA reviews

+	−
Linking ORSA with current risk management system	Lack of evidence of embedding and buy in from senior management board
CRO increasingly responsible for ORSA preparation (before Board input)	Delegation of ownership of the ORSA by the Board to senior management
Material risks usually well documented	Business strategy absent from report
Current capital requirements well evidenced	Lack of forward looking assessment
Good engagement with supervisors	Stress and solvency test not well evidenced
Proactive response to feedback provided	Lack of realistic management actions

6. System of governance

- The EIOPA Guidelines are similar to PRA Rules and expectations

- The notable exceptions are:
  - prudent person principle
  - actuarial function holder
  - outsourcing, particularly intragroup and external

- During 2015, the PRA will be asking Boards and executives questions to gain comfort firms are working towards Solvency II compliance

7. Regulatory reporting

- Category 1-3 firms need to provide their interim reporting for year-end 2014 by the end of June 2015
- Cat 4/5 firms need to provide their Day 1 reporting for year-end 2015 in May 2016
- A recent PRA survey indicated that firms are: progressing well with their work on reporting; have stable templates and taxonomy; and are not expecting any serious issues in meeting regulatory reporting preparatory Guideline requirements
- The more detailed Solvency II reporting requirements will mean the PRA can undertake more detailed analysis than it does today
- Reporting schedules for non-December year-end firms throughout the 3-year transitional phase can be found on the PRA website.

Current timetable for submission of returns for firms and groups with 31 December year end

Firms with non-December year end should speak to supervisors for their submission timetable

2015 | 2016 | 2017

Solvency I Submissions

March 2016
Last Solvency I submission

Solvency II Submissions

Preparatory phase returns
Cat 1-3 firms only

Day 1 returns

SII returns
All directive firms and groups

Solos

1 Jul	25 Nov	20 May	26 May	25 Aug	25 Nov	25 Feb	19 May
Annual	Qrtly	One off	Q1	Q2	Q3	Q4	Annual + NST

Groups

15 Jul	6 Jan 2016	20 May	7 Jul	6 Oct	6 Jan	7 Apr	30 Jun
Annual	Qrtly	One off	Q1	Q2	Q3	Q4	Annual

Smaller Firms

20 May	26 May	25 Aug	25 Nov	25 Feb	19 May
One off	Q1	Q2	Q3	Q4	Annual + NST

Pillar 3 will require firms and groups to make certain reports and templates publically available

- The Pillar 3 reporting requirements under Solvency II focus on two main reports, the Solvency and Financial Condition Report (SFCR) and the Regular Supervision Report (RSR)
- A limited number of quantitative templates and qualitative data are required to be made publically available in the SFCR
- All quantitative templates and a detailed set of qualitative data is required to be reported privately to the regulator in the RSR

Audience		Public (SFCR)	Private (RSR)
Narrative Reports	Type	Qualitative	Qualitative
	Frequency	Annual	• Annual summary • In full every 3 years
Quantitative Reporting Templates	Type	Quantitative	Quantitative
	Frequency	Annual	Annual & Quarterly
National Specific Templates	Frequency	N/A	Annually
Other		Major developments affecting relevance of SFCR will require an updated SFCR	PRA ad-hoc reporting will continue

Reporting requirements include qualitative and quantitative reports

- The Solvency II regime will place new reporting requirements on firms covering both quantitative and qualitative aspects
- The Solvency and Financial Condition Report (SFCR) and the Report to Supervisors (RSR) contain both qualitative and quantitative reports

	Quantitative reporting templates	Narrative reports
Sections covered	• Balance Sheet • Premium claims and expenses • Own funds • Variation analysis • SCR and MCR • Assets • Technical provisions • Reinsurance • Group reporting	• Business and performance • System of governance • Risk profile • Valuation for solvency purposes • Capital management

Notes

- If you have any further questions on SII do contact your **Supervisor** or alternatively our **Firm Enquiries Function** at **PRA.FirmEnquiries@bankofengland.co.uk**

- More information on Solvency II can be found on the Bank of England website at **www.bankofengland.co.uk/solvency2**

Any questions?