BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Solvency II: a view from the regulator

Association of Financial Mutuals

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The Solvency II policy framework is now clear

EU law	**European Directive** Maximum harmonising Rules will be transposed into UK law through the PRA Rulebook by 31st March 2015.
Implementing rules	**Delegated Act – published by Commission 10 October 2014** Directly applicable to firms, PRA will be supervising against those standards
Technical standards	**Further Technical Standards and Guidelines to come** Recent consultations on Set 1 Implementing Technical Standards (ITS) and Guidelines (GLs). Finalised in January 2015 Set 2 ITS and GL to be consulted on in Q1 2015 and finalised in Q3 2015

Both firms and supervisors will have to adapt to the new EU regime

The PRA has provided firms with information to prepare

Successful Solvency II implementation is a priority for the PRA as is finding the right balance between policy stability and providing information to firms

- PRA consultation papers and supervisory statements
  - CP16/14: Transposition of Solvency II: Part 3
  - CP23/14: Solvency II approvals
  - CP24/14: Further measures for implementation
  - CP3/15: Transitional measures and the treatment of participations
  - CP5/15: Solvency II: applying EIOPA's Set 1 Guidelines to PRA-authorised firms
  - SS2/14 – Solvency II: recognition of deferred tax - Updated
- Balance sheet, technical provisions and own funds review in 2014 for Life and GI firms
- Technical actuarial events
- Directors' letters and Paul Fisher letters
- Solvency II Conference: countdown to implementation

The PRA will publish Solvency II policy ahead of transposition and continue to provide information via its website

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 USPs

Other approvals granted or declined by the PRA

2015 data request*

PRA assessments of priority SF firms

PRA assess appropriateness of all other standard formula firms

Ongoing 2014 ORSA reviews

2015 ORSA reviews and 2014 feedback

Firms to assess appropriateness

Firm and PRA continuous evaluation of standard formula appropriateness

*firms not subject to interim reporting requirement

PRA communication to firms
PRA decision/activity
Firm activity

Solvency II approach

- The PRA is and will remain a judgement-led risk-based regulator
  - **But** internal models are far more complex, expert judgement is subjective and PRA has to make significant decisions in a short space of time
- UK regime has withstood shocks of last decade and PRA benefits from having a market consistent approach under the ICA
  - **But** Solvency II is different to current practice in a number of respects and the PRA is using the results of its data collection exercises to assess calibrations of capital
- The existing regime expects regular reporting returns from the industry
  - **But** Solvency II will give the PRA a far greater quantity of data, at a more granular level, than the current regime

Current issues in the UK insurance market

- Insurance companies are navigating in a very uncertain environment
- Low interest rate environment may encourage risk seeking behaviour
- Expectation of capital levels
- Uncertainty of tax rules
- GI
  - Soft market conditions
  - PPOs
- Life
  - Budget reforms

Insurance firms have to rethink their business model in the current uncertain environment

PRA approach to assessing SF SCR appropriateness

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 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

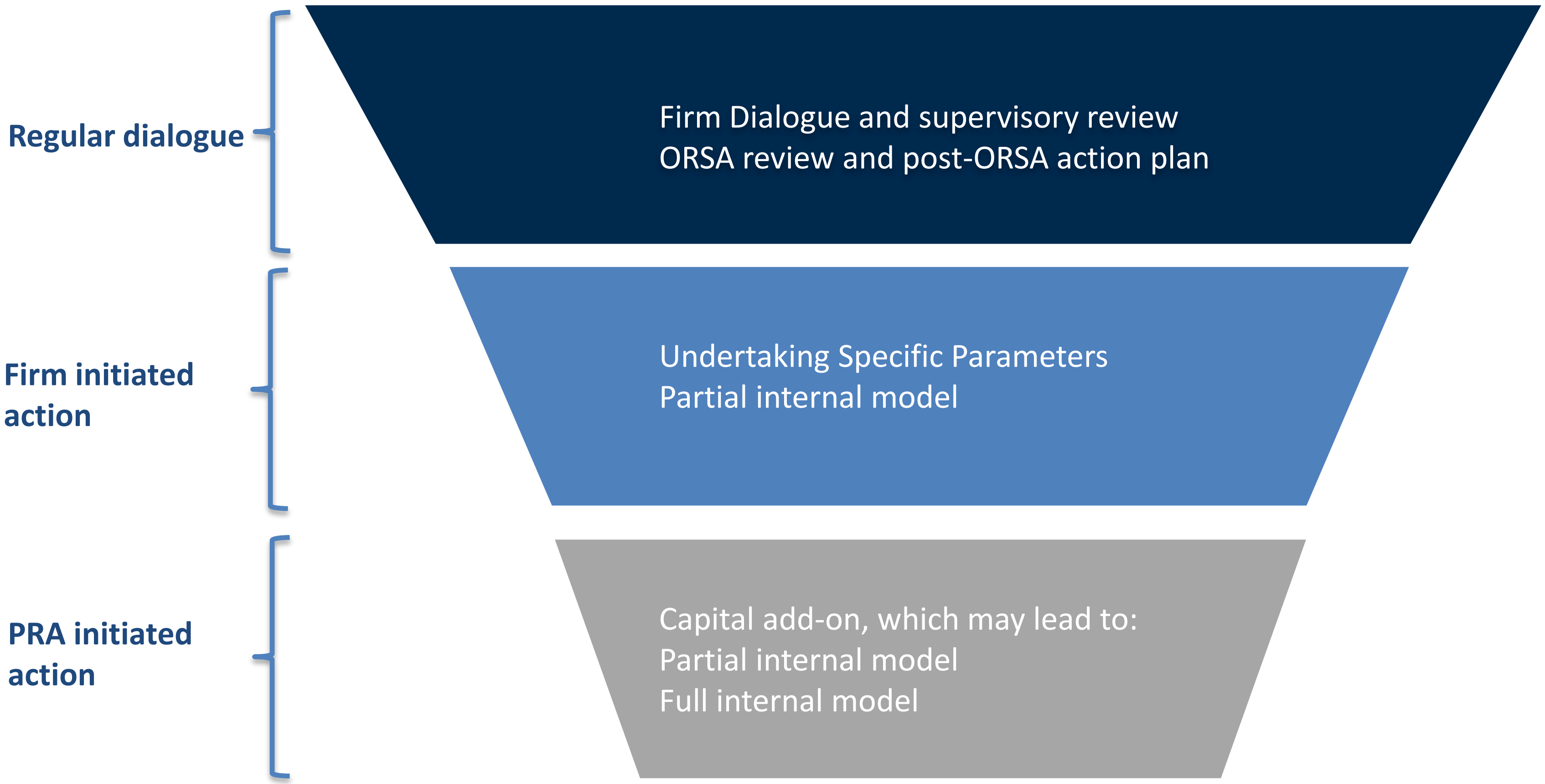
PPOs:
Should be modelled in the life underwriting sub-module (longevity risk).
Long term solution may be to consider use of partial internal model – where proportionate to do so

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



Preparing for Solvency II

PRA supervisory statement 4/13 provided a consistent and convergent framework for firms' preparations towards Solvency II implementation

Forward Looking Assessment of Own Risks

Understanding of own risks

Concise, focused on key issues

Considers business model and strategy

Includes stress and scenario testing

Used by the Board

System of Governance

Risk management and governance

Similar to current Pillar II regime

Need more evidence of prudent person principle and outsourcing arrangements

Crucial role of Board and support from actuarial function

Internal Models

Risk-based capital adequacy

Long running internal model approval process with ICAS+ to help transition

Compressed review timetable

Documentation and validation, more focus on assumptions and justifications

Submission of Information

Reporting the risks

Previously insufficient emphasis on asset composition

Increase in frequency and detail, significant effort to be ready for reporting in summer 2015

EIOPA's preparatory guidelines are an important step towards Solvency II implementation

Lessons from the internal model pre-application phase

Significant gaps that firms still have to close on internal models in order to meet the test and standards required by the Directive	**Key judgments and assumptions** inherent in models are not always highlighted or justified appropriately by firms
	No **appropriate escalation to senior decision makers** for the most material assumptions
	Number of areas where the PRA continues to question the validity of firms' **underlying modelling assumptions**
	Boards and senior management should be engaged to ensure the model meets the needs of the business and will be used in practice

Aspects of the ORSA framework

A key feature of the ORSA framework is the ability to **link the firm's ORSA** process with the PRA's **current supervisory approach**

Purpose: To use the ORSA output as evidence to **support forward looking supervision work** such as capital assessment, business model analysis, risk questions and stress testing review

The ORSA is owned by the risk function but is signed off by the Board

The contents of the ORSA must be used to make firm decisions

The ORSA must support the methodology of calculating the firms' capital requirements

Current practice

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Linking ORSA with current risk management system

CRO increasingly responsible for ORSA preparation (before Board input)

Current capital requirements well evidenced

Material risks are usually well documented

Good engagement with supervisors

Proactive response to feedback provided

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Lack of evidence of embedding and buy in from senior management board

Sometimes perceived as a tick box exercise for regulatory purposes

Business strategy absent from report

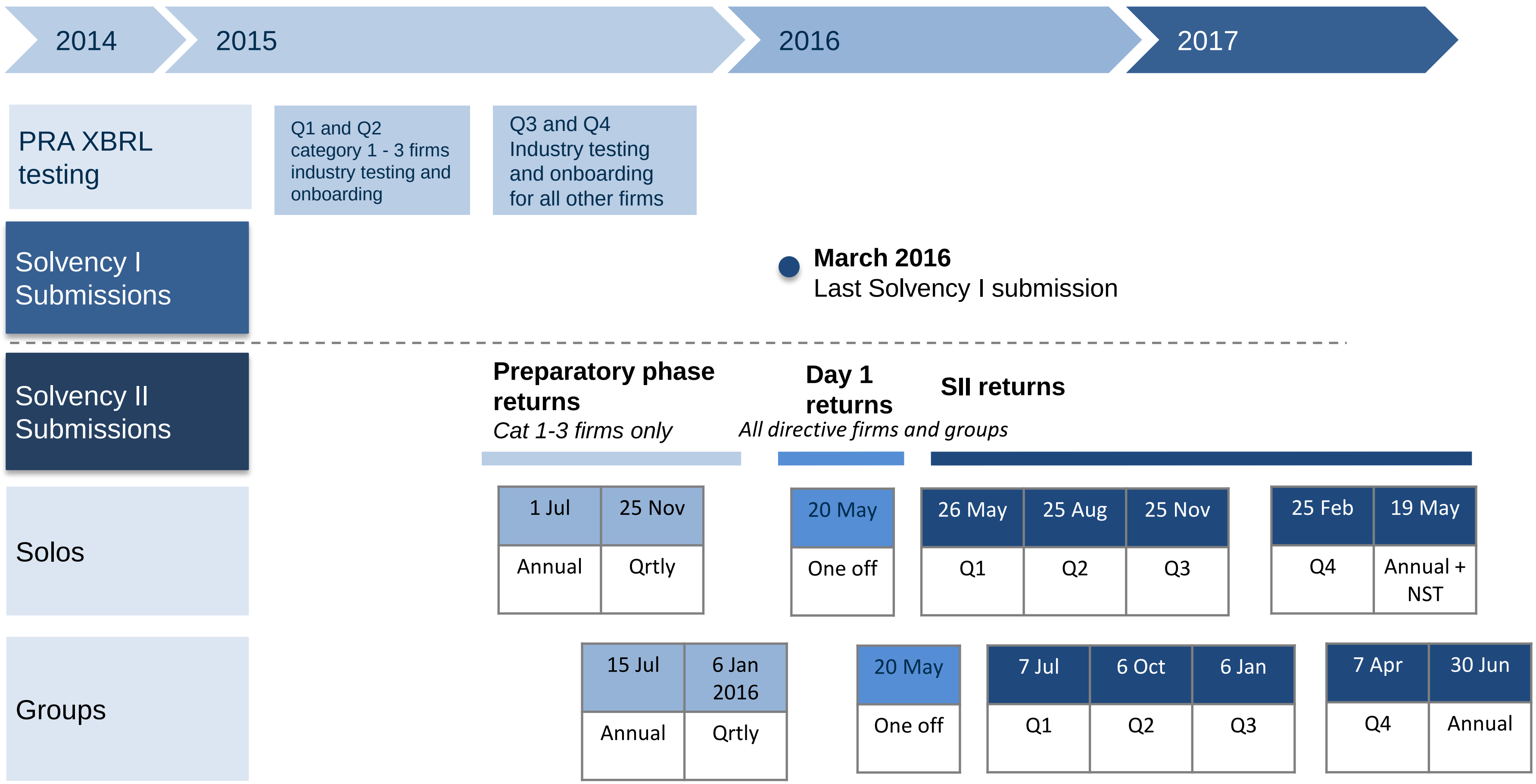
Risk appetite absent from report or not well structured

Lack of forward looking assessment

Stress and solvency test not well evidenced

Lack of realistic management actions

Regulatory reporting



NB: Details dependent on final text.

Summary

- The policy picture has stabilised we now need to move to implementation.
- There are some uncertainties but this should not stop firms being ready on 1 January 2016.
- Standard formula should fit a significant proportion of UK firms.
- The firm should be aware when the standard formula is not appropriate and have a plan to ensure capital levels meet the risk profile; this must be proportionate
- The PRA does have some options when standard formula is not appropriate.
- Non executive directors need to be confident the way the solvency capital requirement is calculated is right for the firm and challenge.
- The ORSA allows you to demonstrate assessment of appropriateness
- Another challenge for this year is the regulatory reporting and non executive directors should understand the new reports and data collection requirements,