Institute
and Faculty
of Actuaries

CP11/19 Solvency II: Maintenance of the transitional measure on technical provisions

IFoA response to the Prudential Regulation Authority

21 August 2019

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Institute
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CP11/19
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

21 August 2019

Dear Sir/ Madam,

IFoA response to Consultation Paper 11/19 Solvency II: Maintenance of the transitional measure on technical provisions

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's consultation paper (CP) on the Maintenance of the Transitional Measure on Technical Provisions (TMTP). A number of parties within the IFoA that are actively engaged with the ongoing determination of the TMTP have been involved in the development of our response.

2. It is important to point out that, as with any IFoA consultation response, we have considered the PRA's TMTP simplification proposals from the perspective of the public interest.

3. The IFoA welcomes the two key aspects of the proposals within the CP:

    - the introduction of simplified methods to recalculate the TMTP; and
    - a change in approach relative to determining the Solvency I/ Solvency II balance sheets, such that consistency of assumptions is required, but not necessarily consistency of methodology.

4. As the PRA note in the CP, the TMTP remains a material component of many insurers' balance sheets.

5. We note that the change of approach to methodology addresses a contradiction between Supervisory Statement SS6/16 (on TMTP) and PRA Policy Statement PS31/18 (on Equity Release Mortgages, ERM). In this regard, the CP11/19 proposals generalise the approach taken with ERM.

6. We agree that it would be difficult to develop a generic, industry-wide approach to TMTP simplification. As the PRA will be aware, and as touched on within CP11/19, the IFoA's TMTP Working Party (WP) provided earlier input to the PRA's TMTP simplification development. The WP had suggested that it would have been challenging to develop a single TMTP simplification formula that could be applied uniformly across the industry; it may also have been difficult to implement in practice.

7. Our view of the proposals is that they place the onus on firms to determine a simplification approach, and then demonstrate to the PRA that the simplification is materially accurate via sufficient validation and back-testing. This seems to be a reasonable approach. The examples of possible simplifications in the draft Supervisory Statement (SS) 6/16 are helpful in:

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a) suggesting that it might be possible to identify the main drivers of the TMTP (such as the risk margin) and allowing only for the recalculation of such components; and
b) simplifying the Financial Resource Requirement (FRR) test for the non-biting Solvency I Pillar, if it is clear that it will remain non-biting.

8. Paragraph 3.3A of the draft amended SS6/16 sets out that firms should calculate the Solvency I technical provisions using the same methodology as at 31 December 2015. This could be interpreted to mean a strict requirement to use the very same methodology applicable at 31 December 2015. We believe that this would be unduly restrictive. Firms continually make improvements to their modelling and may introduce changes to their estimates of balance sheet items. Applying this strict interpretation to, for example, a proposal to decommission a model used to calculate Solvency I Pillar 1 results and use a newer model but which uses a slightly different methodology and produces slightly different results, would presumably not be allowed.

9. In general we would prefer a more flexible, permissive and outcome based approach such that changes to the Solvency I methodology could potentially be applied, subject to discussion with the PRA, provided that the outcome on the TMTP is appropriate. For example, in cases where the vast majority of the TMTP arises due to the risk margin, if the proposed changes deliver a simplified TMTP methodology that continues to give an outcome consistent with this.

10. The CP explains that firms should discuss their proposed methods with their supervisors ahead of the recalculation at 31 December 2019. It would be useful to understand if firms are able to apply any simplification to any earlier recalculation (e.g. following a change in risk profile).

11. Furthermore, it would be useful to clarify whether firms would be able to propose a simplification approach after 31 December 2019. Clearly the 24-month recalculation due at the end of this year is a natural point for firms to aim for, but we suggest the PRA's proposals should also be open to firms which are required to work to a different timetable.

12. A more general point is that firms may already be applying simplifications to their TMTP calculation in one or more components because it is onerous to maintain legacy processes, and there is a need to develop new process such as the calculation of Solvency I and Solvency II technical provisions for business written prior to Solvency II going live. In our view, rather than discussing any simplified approaches with the firm's supervisory team, it would be more appropriate, for a firm's audit committee to be satisfied that the TMTP calculation were appropriate, and for the supervisory team to be contacted by exception. Furthermore, information on approaches taken should also be provided, where requested by the supervisory team.

13. Paragraph 2.4 of the CP explains that further simplifications may be appropriate as the materiality of the TMTP reduces over the remaining transition period. It is not clear to us that the TMTP would actually reduce as a proportion of liabilities for all firms, particularly for those that are not writing new business. This would depend on whether the run-off of the in-force business was faster or slower than the 16-year linear run-off of the TMTP.

14. In addition, given that the TMTP will cease from 1 January 2032, even firms closed to new business and with-long tailed business (such as deferred annuities), should give some thought to running the TMTP off appropriately, so as to avoid a discrete fall in TMTP value when the TMTP ceases.

15. As referenced above, paragraph 3.3A of the amended SS6/16 makes the approach to Solvency I methodology changes consistent with the approach specific to ERM. We support this aspect and note that arguments advanced for why ERM methodology changes should not generally apply to Solvency I are not specific to ERM assets.

16. We also note the following text at the end of paragraph3.3A of the amended SS: *'…the Solvency I approach to the evaluation of new risks to be identical to the Solvency II basis for the purposes of the TMTP calculation unless the firm can sufficiently demonstrate that the risk was addressed in a different way in methodologies used as at 31 December 2015.'* The IFoA believes that this provides a potential loophole in the circumstances where a firm is aware that the Solvency I treatment could be less beneficial, so defaults to the Solvency II approach. However, there is an overriding prudent persons principle which could counter this potential approach.

17. As we note earlier, the PRA's proposals would result in a different approach to changes in assumptions versus methodology. It is therefore conceivable that this could open up an ambiguity between what is considered an assumption as opposed to a methodology. Our interpretation is that this issue is recognised implicitly in the paragraph 3.3A of the SS, asking firms to discuss any query on how the Solvency I basis should be updated with the PRA. It also gives some examples of where this might occur (e.g. with-profits management actions), which could be argued as assumptions or methodology. However, we suggest it would be helpful for the PRA to state explicitly that there is a potential ambiguity between assumptions and methodology, and make this clearer in any revision to this paragraph.

Should you wish to discuss any of the points raised in further detail, please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely,

Tan Suee Chieh

President Elect, Institute and Faculty of Actuaries