Institute and Faculty of Actuaries

CP23/14 Solvency II approvals

Consultation response to the Prudential Regulation Authority

9 January 2014

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Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

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Institute and Faculty of Actuaries

Solvency II approvals
Jean Sanderson
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

9 January 2015

Dear Ms Sanderson

IFoA response to CP23/14 Solvency II approvals and Paul Fisher letter of 15 October 2014

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Prudential Regulation Authority's (PRA) consultation paper on Solvency II approvals and Paul Fisher's October letter.

The IFoA's Solvency II groups have led the drafting of this response. Members of these groups are actively engaged with the implementation of Solvency II by insurers.

Our response to specific matters follows the order in which they appear in the consultation paper.

General Comments

1. We welcome this consultation paper, which sets out the detailed requirements necessary to receive approval on a number of critical aspects of Solvency II. We accept and appreciate that the PRA is working within a very tight timeframe to implement Solvency II.

2. The requirement for firms to produce contingency plans, based on potentially different permutations of approvals received, is likely to create significant additional pressure during an already tight implementation timetable. Whilst we agree that it is appropriate for firms to have contingency plans in place, it would be helpful if the PRA could provide guidance on the anticipated level of detail that should be included within them. We recommend that the complexity of this process is kept to a minimum.

3. Overall, we believe the requirements set out in CP23/14 are proportionate and Paul Fisher's letter has been helpful and informative for our members preparing for implementation. We would, however, welcome further comment letters and application checklists on other aspects of Solvency II approvals.

4. We would also welcome further information on the requirements for the application of volatility adjustments to the risk-free interest rate, of particular interest to with-profits funds, and requirements for pre-approval alongside the topics covered in CP23/14.

5. We believe there are circumstances when the six month period for approval or rejection of applications cannot be justified and adds to the general uncertainty and time pressure leading up to Solvency II going live. For example, for a single group ORSA application, or where an application is relatively simple we would question whether a six month waiting period is

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appropriate. We encourage the PRA to respond to applications as soon as it reasonably can and where possible not utilise the six month response window.

<u>Draft supervisory statement on Solvency II approvals</u>

Applications for Solvency II approvals

6. We would welcome further guidance from the PRA on the likely circumstances in which applications will be accepted or rejected (along similar lines to the Paul Fisher letter), so that our members can focus on the most likely approval request for their firm and in doing so, improve the quality of the application made. If this is not the case, there is a risk that the company submits several "contingent" approvals in short succession. Allowing our members and their firms to target the most likely approval requests should also help to ensure that the PRA is not inundated with approval applications. Such guidance could be given by a range of measures, for example product type, risks faced etc.

7. Recognising that work is currently in development for the industry as a whole, it would be useful to understand to what extent firms could work on a "best efforts" basis for certain approvals, with conditional approval granted for a period of time.

Internal models

8. As it is important for companies to understand capital implications of internal model applications, and to ensure proper capital management through the transition to Solvency II, clarity on key outstanding policy areas (e.g. contract boundaries and the treatment of pension funds) is essential. If uncertainties remain for much longer, internal model applications will need to proceed without full knowledge of the impact of policy decisions on capital.

Matching adjustment (MA)

9. It would be useful to understand the application of materiality and proportionality to the MA application (e.g. for the proportion of unrated assets and liquidity plans), and what the PRA would consider as suitable justification for the chosen approach. For example, reference to other materiality limits within the business, discussion of reasonable resource and cost constraints and the potential impact of choosing a lower materiality threshold.

10. The delay from EIOPA in deciding how the MA will be reflected in the group solvency calculation is causing the industry significant issues. How it is treated will be a major influencing factor in whether, and how, a firm would apply for such an adjustment and the format of potential restructures required to gain matching adjustment eligibility. We urge the PRA to encourage EIOPA to clarify this matter as soon as possible and, as part of this, it would be useful to include an articulation of the EIOPA decision-making process (e.g. consistent with the conceptual framework information included in CP-14-042). Furthermore, we would welcome further details on the PRA's intended approach to providing feedback to those companies who have been involved in the MA pre-application process, particularly if the application of the final EIOPA rules differs from the methodology adopted. We further encourage the PRA to give feedback throughout Q1 2015, as opposed to giving a single feedback announcement at the end of March 2015.

11. We have noted the comment that firms should consider the impact on the internal model if the MA application is rejected. Clarification on whether the MA application will require a contingency plan if the internal model is not approved would be welcomed - we believe that a question remains as to whether the MA under the Standard Formula would be required to be presented as a contingency in the MA application for internal model firms.

12. We note the comment that a review of a firm's internal rating system may be required. It would be useful to understand the circumstances that would give rise to such an investigation,

and would recommend that the PRA publish its thinking in this regard. We would expect this to depend on the proportion or quantity of unrated assets internally rated as above BBB (compared to firm specific materiality levels). In addition, the decision should be based on the strength of evidence of independent review presented within the application of the internal rating process, e.g. by external auditor or third-party.

Ancillary own funds (AOF)

13. We note the PRA's comments that AOF should not be considered as emergency capital, but rather as part of a firm's medium term capital management planning. It would be helpful if the PRA could clarify the definition of medium term capital, as opposed to emergency funding, and explain why it is necessary for the AOF item to not be considered as emergency capital. We would suggest that some of the questions asked in the application checklist imply that AOF is being considered as an emergency funding source (for example question 10 and 34 - 36).

Undertaking Specific Parameters (USP)

14. We would welcome the PRA's clarification on the pre-approval process to be followed for USPs and how these should be incorporated into pre-approval applications for firms.

Exclusion of entity from the scope of group supervision

15. It would be useful to provide guidance on the likely assessment of materiality of specific entities within a Group. In particular, we would like to understand the relationship between the current regime, which allows entities to be excluded according to "de-minimis" provisions and the envisaged approval process for excluding entities from the scope of Solvency II group supervision.

Single Group ORSA

16. We welcome the guidance on providing a single Group ORSA. However, we believe further clarity is required on how the requested information will be used. For example, it is not clear how the Own Funds, SCR and other information provided for each entity will be used in the decision making process - as we understand it, the existence of a centralised risk management system and ability to identify risks are the more important aspects.

Calculation Method for Group Solvency Capital Requirement

17. We welcome the inclusion of operational costs for using Method 1 calculations in the information checklist provided, as the costs of producing information on more than one reporting basis are likely to be significant.

18. For firms wishing to use Method 2 (deduction and aggregation) to calculate their group solvency capital, we would welcome some guidance on how to treat third-country equivalence. This is particularly important for firms that are either en route to achieving transitional equivalence or for those countries where the requirements for equivalence are still being assessed.

19. The checklist requires the assessment of the impact of Method 1 vs. Method 2 (or combination) at an entity level. This is particularly onerous for parts of a Group that are likely to fall under a single equivalent regime, where the rationales for including the entities within that part of the Group on a Method 2 basis are the same. We would therefore request that the assessment can be performed for parts of a business operating in specific territories, rather than at an individual entity level.

20. We have noted the requirement for providing detail on intra-group transactions, where Method 2 / combination approaches are adopted and the significance of the 10 per cent threshold for such transactions. We would expect that the rationale for including these transactions would

be to ensure that they are treated appropriately in the group calculation approach, rather than as a justification for the calculation not being appropriate for a firm.

<u>Paul Fisher's letter</u>

21. The IFoA would welcome the opportunity to meet with the PRA to discuss the issues of interpretation this letter raises for asset trading, reassurance and diversification. We also note the following, where we would welcome further explanation:

    a. On page 8, "cash items", the conditions pertaining to cash holdings appear inconsistent with efficient portfolio management.

    b. On page 18, management of the MA portfolio, there is a suggestion in bullets (b) and (c) (where monthly and quarterly frequencies are noted) that there may be minimum acceptable frequencies. It would be useful to confirm if that was the case.

    c. On page 18, the PRA's expectation that firms evidence a process by which trades within the MA portfolio are regularly reported to senior management, does not have any allowance for materiality. It would be useful to give guidance on the level of trading that might be acceptable, allowing for the fact that the portfolio should be held to maturity. However, it is generally assumed that a level of trading would be practical.

Should you wish to discuss any of the points raised in further detail please contact Michelle Walsh, Interim Technical Policy Manager (michelle.walsh@actuaries.org.uk 0207 632 1471) in the first instance.

Yours sincerely

David Hare
Immediate Past President, Institute and Faculty of Actuaries