Institute
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CP3/15 SII: transitional measures and the treatment of participations

IFoA response to the Prudential Regulation Authority

20 February 2015

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Institute and Faculty of Actuaries

SII: CP3/15 Response
Romain Labaune
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

20 February 2015

Dear Mr Labaune

IFoA response to CP3/15 SII: transitional measures and the treatment of participations

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Prudential Regulation Authority's (PRA) consultation paper on SII transitional measures and the treatment of participations. The IFoA's Life Consultations and Standards Subcommittee has led the drafting of this response. Members of this group are actively engaged with the implementation of Solvency II by insurers and include members performing, or who have performed, controlled function roles.

2. We welcome the clarity this consultation provides but have a few questions, as well as suggestions around how this clarity may be improved. We would highlight as our main concerns our questions on the risk free interest rate/ technical provision transitional measures: (a) whether the discount rate is static or dynamic and (b) what constitutes the comparable minimum Solvency I Directive level of reserves.

3. We are concerned that the description of the Solvency I risk-free interest rate in Paragraph 10.1 (Appendix 1.1), is unclear. Naturally the "interest rate" under INSPRU is in practice a variety of rates depending on the backing assets, whether the technical provision is positive or negative, etc. The Supervisory Statement tries to address this at 2.1. We were unsure why the same wording, the "annual effective rate" of 10.1 (2), is not used for 10.1 (1) if this is the comparison the PRA desires to see.

4. It could be read as saying the discount rate should be static, determined on a one-off basis as at 31 December 2015 and fixed thereafter. However it could also be understood to mean the discount rate should be dynamic, determined on an ongoing basis from period-to-period reflecting existing assets, but using the INSPRU method as at 31 December 2015. We believe a dynamic approach is more appropriate because it reflects the matching of assets and liabilities and the need for a discount rate that fully reflects current market conditions. We suggest the wording of paragraph 10.1(1) is revised to avoid confusion, perhaps to say "the interest rate as determined by the firm reflecting conditions at each future valuation date, but based on the method used under INSPRU 3.1.28R to INSPRU 3.1.47R of the PRA Handbook as at 31 December 2015".

5. We note the rules have had to repeat the oddity of the Solvency II Directive Article 308c (as amended by Omnibus II), that any volatility adjustment must be included in coming to the transitional (under 10.3) but then (under 10.4(1)) a restriction is introduced into the calculation

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of the volatility adjustment. We are unsure of the rationale for this. The wording of 10.4(1) is unusual, as is the Directive, and talks of “in the calculation of the volatility adjustment”. We wondered whether there was any special interpretation the PRA was making here.

6. We do not understand the rationale for introducing a new valuation basis which looks to the current Directives. This appears to potentially introduce a new calculation which is not currently produced by firms.

7. We are also concerned that by applying the test to the higher of the Solvency I Pillar 1 or Pillar 2 reserves we will create anomalies between situations where firms are unable to obtain transitional relief despite their overall capital position worsening under Solvency II particularly in cases where the Pillar 1 reserves are higher than both the Pillar 2 reserves and the Solvency II technical provisions. This is likely to be the case for unit linked business and therefore we may also have different treatments between firms depending on their mix of business.

8. We therefore believe it would be simpler to calculate the Technical Provisions transitional deduction by reference to the Best Estimate Liabilities, as calculated under the current Solvency I Pillar 2 regime. However, we do accept that the deduction should be subject to an overall cap by ensuring that excess assets over the financial resources requirement are no higher than before the introduction of Solvency II; in particular, firms should allow for the more onerous of Pillars 1/ 2 under the current UK Solvency I regime.

9. We note the complexity the PRA has given to the Technical Provisions transitional deduction by including the option in 11.3(2) (a) of a comparison to a valuation basis that meets the current Directives rather than meets INSPRU1. However, the interpretation of the Directive requirement over reserving for any guaranteed surrender value would benefit from PRA commentary. It is a question of interpretation whether surrender values on unit linked policies have to be treated as "guaranteed" under the terms of the Solvency I Directive for the purposes of the adjusted INSPRU7 result possible under this consultation. We would ask whether the PRA have any definite views here as the point could be material for a number of firms. In addition, we note that there are a number of particular issues with the introduction of such a “current Directives” basis. Clearly, there is no market precedent or auditor oversight, so we can envisage a number of difficulties with firms assessing and getting agreement on such a basis. Are the PRA considering giving any guidance in this area?

10. The document is largely silent on the interaction between different homogenous risk groups, particularly if some of those are within Ring-Fenced Funds:

    a. If we take a specimen firm with a With-Profit fund and a Non-Profit fund, composed of (say) annuity business only. It would be usual for the Non-Profit fund to have mathematical reserves under Solvency I Pillar 1 which would be higher than the Best Estimate Liabilities under Solvency I Pillar 2. It would be common for the WP liabilities under Pillar 2 to be higher than Pillar 1. In these circumstances, we suggest that greater clarity is provided on whether homogenous risk groups versus entity level calculations can be selected at the discretion of the firm
    b. What are the expected implications where a company level capital requirement is supported by a transitional measure perhaps substantially arising from liabilities inside a Ring Fenced Fund?

11. Paragraph 3.13 notes that the financial resources requirement comparison should be calculated as at 1 January 2016 when applying to use the transitional deduction. The

application will be agreed prior to this date so, therefore, what is the expectation around any projected position as at 1 January 2016 that should be included in the application? This is particularly relevant given that levels of imposed capital add-on are referenced as being included in the calculation.

12. It would also be useful to clarify whether the annual re-assessment noted in paragraph 3.16 can be performed approximately for the Solvency I financial resource requirement or whether a full recalculation is expected. We assume that an approximation is reasonable, particularly where the Pillar 2 requirement is the biting Solvency I constraint, but this clarification would be very helpful for the industry. Further, the circumstances where it is envisaged that firms will be retested are not clear, particularly if they have engaged in re-constructions and / or Part VII court schemes. It would be counter-productive if firms were to find themselves in a situation where they were effectively prevented from undertaking sensible capital management/ optimisation activities because of a potential loss of transitional measures.

13. The transitional deduction is set out as a firm level calculation that, for a composite insurer, could encompass both life and non-life technical provisions. We noted that:
    a. The Supervisory Statement at 3.17 talks of its application at a "homogeneous risk group" level. That paragraph does not seem to impose any overall firm level cap on the amount of the transitional at a "homogeneous risk group" level. Is the intention that a cap would form part of the application?
    b. The Supervisory Statement talks at 4.5 of a potential external validation of the calculations performed. The timings for this approval, and the other often interlinked approvals under Solvency II, will be tight and the validation might have to address paragraph 5 above. We suggest the validation work should be to a review standard and not the audit standard of the current Solvency II balance sheet activity.

14. With regard to Appendix 2.2 "Solvency II – the internal model treatment of participations", we note that it is proposed that any obstacles to transferring capital between entities are allowed for in the assessment of the solo capital position as well as the Group. This may put mutuals with insurance subsidiaries at a disadvantage to proprietaries; mutual firms will often be unable to amend their structure, whereas proprietaries will, if they wish, be able to move to having the insurance company as a sister company rather than as a subsidiary.

15. We would welcome clarification from the PRA about the form and level of detail an application for using transitional measures should take. It would also be helpful to know whether approval is essentially automatic if the requirements of the regulations are met or if the PRA will use its discretion in approving applications.

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,

James Crispin

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Chair, Life Board, Institute and Faculty of Actuaries