



Institute
and Faculty
of Actuaries

CP5/15 Solvency II: applying EIOPA's Set 1 Guidelines to PRA- authorised firms

IFoA response to the Prudential Regulation
Authority

24 March 2015

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

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.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.



SII: CP5/15 Response
Jack Middleton
Prudential Regulation Authority
20 Moorgate
London
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24 March 2015

Dear Jack

IFoA response to CP5/15 SII: applying EIOPA's Set 1 Guidelines to PRA-authorized firms

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Prudential Regulation Authority's (PRA) consultation paper on the application of EIOPA's Set 1 Guidelines to PRA-authorized firms. The IFoA's Life Board has led the drafting of this response. Members of this board are actively engaged with the implementation of Solvency II (SII) by insurers, including in the context of with-profits funds.
2. We welcome the clarity this consultation provides, particularly in setting out the PRA's expectations of PRA-authorized firms in relation to the EIOPA Set 1 SII guidelines. We note the PRA's expectation that firms should comply with all of those Set 1 Guidelines that apply to them, in a proportionate manner. Our main comment on this consultation relates to the EIOPA Set 1 SII Guidelines on Ring-Fenced Funds.

Ring-Fenced Funds: EIOPA Guidelines 6-8

3. We suggest that Guidelines 6-8 are ambiguous in their application to the different types of with-profits arrangements operated by UK life insurers. The Feedback Statement included in EIOPA's Final Report on Public Consultation No. 14/036 included Guidelines on Ring-Fenced Funds. We believe this indicated that the intention behind Guidelines 6-8 was to provide sufficient flexibility to appropriately reflect the attribution of cash flows between a Ring-Fenced Fund and the remainder of the undertaking. In particular, that the assets in a Ring-Fenced Fund should be identified with respect to the specific contractual/ legal/ other restrictions relating to the Ring-Fenced Fund. However, taken in isolation of this Feedback Statement, the interpretation of these Guidelines is less clear.
4. The text of Guideline 8 suggests that it is only applicable where shareholder transfers are expressed in terms of bonuses allocated to with-profits policyholders. Where a scheme of demutualisation requires shareholder transfers to be determined by cash flows based on charges less expenses, rather than a share of bonus payments, then Guideline 8 could be interpreted as saying that these correspond to restricted items of own funds. They would then be potentially subject to a 'haircut' under Article 81 of the Delegated Acts, even if there was no contingency on their emergence, or if they would only be withheld to the extent necessary so that the fund could meet its obligations to policyholders.
5. We are therefore concerned that, without establishment of further principles, Guideline 8 may be interpreted in a way which produces reported outcomes that do not appropriately reflect

the economic effect of attributions of cash flows between a Ring-Fenced Fund and the remainder of the undertaking. We consider that this could result in inconsistencies between firms and would not reflect the economic effect of different forms of shareholder transfers (therefore distorting own funds).

6. The ambiguity over Guideline 8 could be a significant point for firms depending on the design of their demutualisation scheme. Without further clarity from the PRA, firms may have no alternative but to agree with their external auditors an interpretation which does not realistically reflect the economic effect of the scheme settlement. To avoid this we recommend that the PRA adopt an approach to the definition of Ring-Fenced Fund assets and liabilities that is sufficiently flexible to reflect the economic effect of different definitions of shareholder transfers.
7. We also recommend that the PRA sets out principles around how Guidelines 6-8 are to be applied in the context of UK-specific practice. The principles should be sufficiently flexible to appropriately reflect the economic impact of different forms of with-profits arrangements in the UK, including transfers wider than those based on shareholders' share of discretionary bonuses. We believe this would be in line with the intentions expressed by EIOPA in their Feedback Statement.

We have one further comment relating to Ring-Fenced Funds:

Ring-Fenced Funds: Qualification of With Profits

8. Paragraph 5.3 of the Draft Supervisory Statement in PRA CP5/15 cross- refers to PRA CP22/14, and its expectation that each with-profits fund would constitute a Ring-Fenced Fund. We note however, that what CP22/14 actually says is slightly different: *"The PRA expects that such restrictions will **generally** mean that each with profits fund displays the characteristics of a Ring-Fenced Fund."* That is more circumspect than the CP5/15 phraseology and leaves it more open to some with-profit funds not being ring-fenced (e.g. the main fund of mutual firms). We suggest it would be preferable to use something similar to the CP22/14 wording in the supervisory statement for PRA-authorised firms.

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,



David Hare,
Immediate Past President, Institute and Faculty of Actuaries