Institute
and Faculty
of Actuaries

CP22/17: Supervisory approval for the volatility adjustment

IFoA response to Prudential Regulation Authority

9 February 2018

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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.

Institute and Faculty of Actuaries

CP22/17
Mudi Ugono
Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

9 February 2018

Dear Mudi,

IFoA response to Consultation Paper CP22/17: Supervisory approval for the volatility adjustment

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's consultation paper (CP) on supervisory approval for the Volatility Adjustment (VA). Our Life Standards and Consultations sub-Committee (LSCC) and Life Insurance Board have been involved in the drafting of this response. Members of the LSCC and Board are actively engaged with the operation and management of the VA by life insurers.

General Comments

2. The CP is helpful in clarifying the PRA's expectations in relation to an application to use the VA. However, we consider the scope of the proposed changes outlined in the CP to be limited in light of the current landscape. Relevant recent developments include:

   - the Treasury Committee's conclusions in their inquiry into Solvency II (SII) in the UK, published in October 2017; and
   - EIOPA's November 2017 Opinion on the supervisory assessment of internal models including a dynamic volatility adjustment (EIOPA-BoS-17/366).

3. We would welcome a more comprehensive review of the VA approval process, with scope including:

   - whether there could be cases without a need for regulatory approval;
   - the use of a dynamic VA; and
   - consideration of the VA approval timescales, for example the possible use of an 'emergency' VA.

4. All of the above would support the objective of the VA to avoid pro-cyclical behaviours. A clearer path to VA approval would offer firms another route to managing their position in times of spread volatility. A dynamic VA would embed this for internal model firms and better reflect a firm's anticipated position and capital needs after a spread movement. Lastly, the regulator indicating it would support the industry through some form of emergency VA approval process would again help avoid unhelpful 'crowd behaviour' in response to a market spike in spreads. We suggest the PRA should reconsider the rigidity of a VA approval process that does not have these secondary avenues to help firms. All, or a combination of , these avenues of risk management would support counter cyclical reaction to a sharp spike in spreads where this is not of itself an indicator of risk, but rather market turbulence.

Comments on proposed amendments to Supervisory Statement SS 23/15

5. Paragraph 2.3 of the CP sets out a requirement for firms to consider 'whether the application is consistent with the intended purpose of the VA', when making an application to use a VA. This requirement seems odd in the generally 'rules based' nature of the SII regime, and requires some interpretation of what the intended purpose of the VA was. It seems clear that the VA was intended to be a simple and mechanical addition to the discount rate, and hence justifying the VA by reference to its intended purpose seems excessive.

6. We acknowledge that the proposed governance process set out in paragraph 2.4 of the amended SS is reasonable overall. However, we believe the advice sought by the governing body should be at their discretion. The requirement to obtain advice both from the Actuarial Function and from the Chief Actuary is likely to lead to duplication where the Chief Actuary leads the Actuarial Function.

7. We have a number of observations on paragraph 2A2 of the draft SS:

    - we would agree that the purpose of the VA is to reduce the impact of short term market volatility on insurers' long term assets and liabilities, and in so doing, to avoid pro-cyclical investment behaviour;
    - the draft explains that 'the purpose of the VA is not to help smooth volatility in the SII balance sheet arising from movements in the risk-free rate'. This seems to some degree at odds with the subsequent assertion that 'the VA aims to mitigate 'artificial' balance sheet volatility caused by short-term market volatility in the value of assets', since the latter can be caused by the former;
    - overall, we are unclear whether the comments on the purpose of VA in the CP are adding any further clarity over and above the Omnibus II recital to which the PRA refers.

8. The reference to 'undue capital relief' in paragraph 2A3 would benefit from further explanation. In general, an increase in the liability discount rate would be expected to reduce the capital requirement, but this is a legitimate function of using a discount rate which is more reflective of asset holdings. There may be cases where the stresses under the SCR would result in the forced sale of assets at depressed prices, which would in turn invalidate the VA.

9. Paragraph 3.8A3 states that 'firms should also ensure that the SCR calculation is appropriately updated to reflect the firm's use of the VA', but a later comment asserts that firms are prevented by the Directive 'from reflecting the risk of loss of basic own funds resulting from changes to the VA in the SCR'. We therefore understand 3.8A3 to mean only that the VA should be allowed for in the SCR. This interpretation should however be clarified.

10. We agree that the effect of the VA should be reflected in the ORSA, both where it may heighten risk (e.g. liquidity and reinvestment risk), and where it may mitigate risk (e.g. credit spreads widening).

11. The final part of paragraph 3.8A5 explains that firms consider 'any material basis risk that results from divergences between the assets they hold and those underlying the EIOPA reference portfolio'. However we also note that paragraph 3.9 requires firms to assess their ability to earn the VA in practice. Hence it would be helpful to clarify what additional assessment is required in respect of the consideration of basis risk.

12. The revised wording in paragraph 3.9 refers to assets a firm 'intends to hold in future, following the investment of future premium income or asset maturity proceeds' and 'assets they intend to purchase at a future date'. This implies that a VA application can be made on policies where there might currently be no physical backing assets (e.g. due to a negative best estimate liability), but where there would be such assets in future. We would welcome explicit clarification of this point in the final SS.

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

Colin Wilson

Immediate Past President, Institute and Faculty of Actuaries