BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Questions and answers collated at the PRA's Solvency II industry briefings on 12 December 2013

Notes:

1. The responsibility for understanding the requirements of Solvency II and demonstrating that the evidence meets these requirements remains with firms. The information provided here collates the questions and answers (Q&As) from the PRA's two Solvency II industry briefings held on 12 December 2013. At the beginning of the Solvency II regime firms will need to ensure that they are compliant with the relevant requirements.
2. The Q&As are presented under topic headings as noted at the briefings and in a way that draws out the key messages for the reader.

Proportionality

Q1: How will the PRA apply proportionality?

A1:

- The PRA already applies proportionality in the current regime.
- For Solvency II, we will continue to adapt the approach to reviews to reflect the nature, scale, and complexity of the insurer's business. This doesn't mean the PRA will ignore any requirements, but that we'll apply a relatively higher view of the work we do in some areas.
- Similarly, the application of proportionality by firms does not mean that firms can opt out of meeting requirements because they are too onerous.
- Examples of how the PRA is applying proportionality include:
  - The grouping of the 300 or so requirements in the Level 1 and November 2001 draft Level 2 text into 15 key decision criteria to assist our reviews. This enables us to be proportionate, while also discharging the requirements that Solvency II places on us.
  - The work with firms in ICAS+ we're getting the firms submissions, we're analysing those, and really focusing in on those areas that move the dial the most. So they're either the most material to the ICA calculation or have the potential to be material.
- Firms can assist the PRA to apply proportionality by being clear and able to articulate the key risks to the business and its model, including any key drivers for potential volatility, to give us a view of where review time should be spent. This will give us a good starting point for a discussion.

Q2: How will Solvency II be applied to insurers that have been in run-off for years and have just a few claims left?

A2:

- This has a two-part answer:
  1. In the present-day Solvency I environment run-off has served the UK insurance market well and is a viable and useful exit strategy for firms that can produce the right regulatory outcomes. The PRA supports the concept of run-off as it has a very important place in the

market. Currently, there are certain things we can do to make sure that the way we regulate and supervise firms in run-off is proportionate to the way they operate.

ii. Under Solvency II we need to make sure that our approach to run-off is compliant with the requirements of the Directive. The final approach is still to be decided but we are hopeful that Solvency II and run-off will be able to live together.

Q3: How will Solvency II be applied to insurers that have 100% reinsurance in place?

A3:

- We will take the same approach as to other firms, i.e. we will look at the nature, scale and complexity of the insurer's business. As for run-off firms, we will need to ensure that the approach we take is consistent with the requirements of Solvency II.
- We will need to understand how we conduct a review of an internal model or the appropriateness of the standard formula, and the firm's own risk and solvency assessment (ORSA) because when things are reinsured, it doesn't eliminate risk, it simply transforms it from an insurance risk to a credit risk.

Q4: How will the PRA apply proportionality to risks of different materiality within the same firm?

A4:

- Before any review, there is a planning session, where we consider the risks and decide which to focus on as we do not focus on them all to the same intensity.
- We do not pre-empt or pre-state the key risks as these will differ based on the firm.
- We will also be taking a forward-looking approach, so asking not just what proportion of the total risk is assumed at the moment by whatever risk category, but how might that change and in what possible future states of the world.
- We are taking a more dynamic approach to the evaluation of risks and expect firms to do this as part of their business model analysis and stress testing.

Q5: How can firms make it easier for the PRA to apply proportionality?

A5:

- Firms can articulate their own views of materiality across the whole spectrum of risks to the business. This can inform the review work that we do. We may disagree with the firm's view of the landscape, but the assessment will be a useful starting point for discussions and ultimately to the forming of our judgements.

Q6: Will the PRA reflect its proportionate approach in being more pragmatic in its request for documentation, which has been experienced as adding little value for the cost incurred in producing it?

A6:

- Firms are asked to reflect on two things:
  i. Through the use of an internal model, Solvency II allows the firm to determine its Pillar 1 regulatory capital requirement. As such it is critical that the model does not produce a point-in-time capital requirement but is able to produce an assessment of capital in future states of the world to the meet the Solvency II calibration requirement (i.e. 99.5% over a one-year period). This requires more thought and as a consequence more documentation for the firm to demonstrate that it meets the requirements and for the PRA to be able to make a judgement.
  ii. The use of expert judgement and being able to evidence the reasoning of that judgement. This is an area that we have received criticism from firms that we are requesting an unreasonable amount of documentation. The point is that it's often not that we disagree with the reasonableness of the judgement, but question whether it's an unreasoned judgement. Firms have been asked why they have made the judgement, and how it may have been considered and/or compared with other options.
- From our experience there is definitely a need for an improvement in the quality of documentation. The PRA has compiled examples of good and bad practice to help us to review documentation submitted by firms in the internal model approval process (IMAP). The document is available on the IMAP page on the Bank's website and all firms are encouraged to refer to it.

Q7: My firm feels that there's been a lot more scrutiny on quantitative rather than qualitative aspects of the internal model and we have been asked for more documentation, when we feel that overall we have got the right controls in place. Is this being proportionate?

A7:

- As noted above, the PRA will plan its review of an insurer based on its knowledge and experience of the firm's risks and business model.
- When a firm does not understand the approach that the PRA is taking to its review, or why it is requesting information, it should start by asking the supervisory team.

Q8: Will the PRA be revisiting review work due to the passage of time or changes in supervisors?

A8:

- The PRA has no aspiration to revisit review work already conducted and concluded. There may be a review some time in 2015 where we bring all component parts of the reviews together for the firm so that we can make supervisory judgements.

PRA's Supervisory Statement 4/13

Q9: What are the PRA's expectations of firms in relation to EIOPA's preparatory guidelines?

A9:

- The PRA has set out its expectations of firms in Supervisory Statement 4/13 'Applying EIOPA's preparatory guidelines to PRA-authorised firms'. In an accompanying video Julian Adams, Executive Director of Insurance at the Bank of England, explains: i) what a PRA Supervisory Statement is; ii) why this statement is important; and iii) what insurers need to do.
- All materials are available on the Preparing for Solvency II page of the Bank's website.

Q10: Do the PRA's expectations in relation to EIOPA's preparatory guidelines apply to standard formula firms and internal model firms?

A10:

- Yes, the PRA's expectations apply to standard formula firms in three of the four areas in EIOPA's preparatory guidelines (System of Governance, ORSA and Reporting) with the addition of Pre-application for Internal Models for firms intending to apply to use an internal model.
- Firms are reminded that EIOPA has applied a threshold for the reporting guidelines. The PRA will be writing to firms in January 2014 to confirm whether they are in scope for reporting during the preparatory period.

Q11: What length of notice will the PRA give to firms as to when they should submit their ORSA in 2014 and 2015?

A11:

- The PRA is not setting out a timeline for firms.
- EIOPA's guidelines specify a timescale for when firms should submit their ORSA based on their internal systems and processes. It will be for the firm to notify the PRA of when they will be submitting their ORSA.
- This approach may result in the PRA receiving a high volume of ORSAs during a certain period of the year as firms follow similar processes based on their financial year end. This will mean that the PRA may have to stagger reviews giving feedback when we are able and as required.

Q12: Does a firm need an internal model to do the ORSA properly?

A12:

- A firm does not need an internal model to do an ORSA properly.
- Firms will need to demonstrate an understanding of their business, and the dynamics within it, to do an ORSA properly. While this does not have to be done with an internal model, firms may choose to develop the capability to demonstrate how it meets the requirements, including for instance the ability to make projections, assess any sensitivities, and to perform stress and scenario testing on which the firm bases its business decisions.

Q13: How should general insurers incorporate the one-year and ultimate view of risk in the ORSA and standard formula?

A13:

- General insurers should use the one-year view in its Pillar 1 calculation for Solvency II – whether using an internal model or the standard formula – as this will need to be calibrated to the Solvency II requirement of 99.5% over a one-year period. This will set your Solvency II regulatory capital.
- General insurers may wish to take an ultimate view of risk in the forward-looking ORSA, but this will not form part of the regulatory capital calculation.

Q14: Who should the ORSA be written for given it can serve so many purposes?

A14:

- The ORSA should be written for the firm's own use, being its *own* risk and solvency assessment.

Q15: Does the PRA think that the Boards of insurance firms are doing enough to satisfy EIOPA's preparatory guidelines, or should they be doing anything more and/or differently?

A15:

- There are more detailed expectations of Boards in EIOPA's preparatory guidelines relating to Systems of Governance. As we move to Solvency II, firms will need to understand and apply the requirements so that they are able to demonstrate that they meet them in any governance reviews that we conduct.
- There are also additional requirements for groups, including group governance, group requirements, and while these are consistent with the PRA's regulatory approach there is more detail about group governance requirements in the European policy text.

Q16: What is the appropriate amount of Board interaction and time in shaping and reviewing the firm's ORSA?

A16:

- It's impossible to quantify how much is right for an individual organisation.
- It's the firm's ORSA therefore it is an internal decision. As a minimum, we expect the ORSA to be discussed by the Board and to be used as a tool for managing the business. This may be done in a number of different ways, e.g. discussing the ORSA at a specific Board meeting, at regular intervals determined by the Board, or at different times perhaps looking at certain aspects of the ORSA.

Q17: When will firms have more clarity on areas of outstanding policy, including those where the UK has discretion and how it will be applied?

A17:

- EIOPA plans to publish a technical annex which will support the determination and valuation of the balance sheet for the purposes of the ORSA for the preparatory period. We expect it will include some important assumptions for the purposes of helping people to prepare their ORSA valuations and some of their reporting valuations.
- For the Solvency II regime, we and firms will need to wait for the final policy text over the next year or so.
- In the meantime, firms should form a view of what the position might be under different scenarios and the contingency plan. We're looking to understand the differences that might arise at certain points in time and what you would do under certain circumstances, if those were to crystallise.
- When policy is finalised we will look at the decisions and judgements firms are taking on the basis of the forward-looking assessment.

Q18: Is the PRA able to give any indication of the firms that will be in scope for reporting during the preparatory period?

A18:

- The PRA will be applying EIOPA's thresholds based on market share which means that the focus is on the most significant firms in the UK market. Broadly speaking, this translates to bring into scope firms in PRA Categories 1, 2 and 3. However, there are characteristics that we need to take into account, such as the application of the thresholds to groups and firms within groups.

- Formal notification will be sent to individual firms in January 2014.

Q19: Will there be any additional reporting templates from the PRA for Solvency II?
A19:

- The PRA is developing national specific templates for reporting.
- The PRA will consult on these in the usual way, and is very aware of the need for an appropriate lead time for firms to understand the content and timing for submission.
- We will use the regulatory reporting industry working group as a forum for discussion and to understand the implications for firms. Information is available on the Preparing for Solvency II page of the Bank's website.
- Firms will note that in the Supervisory Statement we state that XBRL is the PRA's preferred approach for the Solvency II returns. We will need to consider the approach for national specific templates when we know what the content is going to be, being mindful to reduce the burden on us and firms as far as possible.

Q20: Is the PRA expecting the interim templates to be submitted in XBRL and if so, why?
A20:

- Yes, we are expecting the interim templates to be submitted in XBRL. This is because firms will be expected to submit returns in XBRL for Solvency II and we think it reasonable to expect firms to be ready to submit information six months before implementation.

Q21: Is it possible for firms to submit incomplete returns during the preparatory phase?
A21:

- Yes, it is possible as the focus is on preparations. However, we will be looking at what the gaps are and how significant they are. , If we think that the firm should be more prepared then we may choose to consider what we need to do. However, if there is a sound justification for gaps or why things aren't ready then we won't be as challenging if we are satisfied that the situation is on track for the implementation of Solvency II.
- Firms are encouraged to discuss progress and any issues as soon as possible with their usual supervisory contact.

Standard formula

Q22: What should standard formula firms do where there are a small number of risks that are not adequately captured by the standard formula?
A22:

- Where this is the case, firms will need to consider whether using undertaking specific parameters, or developing a partial or full internal model would be more appropriate and reflective of its risk profile.
- Firms are reminded that models do not need to be overly complex and should be fit for purpose so a pragmatic and proportionate approach can be used by firms. The model will also need to meet the tests and standards in the Directive.
- The standard formula has been developed with a view to a large number of firms being able to use it. If there are a small number of risks to be modelled, this can sit alongside the standard formula and deliver the supervisory outcomes of safety and soundness, and policyholder protection.

Q23: What is the timeframe for a standard formula firm that wants to develop a partial internal model?
A23:

- In Solvency II, NCAs will have six months to make a determination on an application to use an internal model received from a firm.
- If it's a query about developing a model for day one, firms should raise this with their usual supervisory contact as a matter of urgency so that any work can be factored into the PRA's plans for the next 18-24 months.

Q24: Will the PRA use capital add-ons as a matter of course with standard formula firms?
A24:

- Under ICAS, the PRA uses capital add-ons as an effective supervisory tool when assessing the regulatory capital required by firms.
- In Solvency II, capital add-ons have a different role to play in supervision. The Directive sets out the purpose of capital add-ons and the specific circumstances in which they may be applied by NCAs to firms. Details of the process will follow in implementing technical standards.
- Capital add-ons may be applied to firms where the standard formula does not adequately reflect the risk profile of the firm. However, the first question the firm should ask itself is whether the standard formula is appropriate, or whether it needs to use undertaking specific parameters, or develop a partial or full internal model.
- Firms are also reminded that internal models do not need to be overly complex but be as simple as possible to capture the risks within the firm. The key is to adopt an approach to the calculation of the SCR that is fit for purpose.

Early warning indicators (EWIs)

Q25: What is the latest update on the development of EWIs?
A25:

- The PRA remains committed to the policy to use EWIs with internal model firms in Solvency II.
- Currently, we are collecting data from firms to assess the stability of the indicators over time.
- We have found that the initial calibration of the EWIs is not performing as expected. For instance, we know that for general insurers, the premium cycle affects the performance of the EWI and for with-profits firms, the de-risking can affect the stability of the indicators. We are seeking to improve this end 2013/early 2014 so that we have a non-modelled indicator at the 1 in 200 confidence level that holds to the principles set out Julian Adams' letter of 28 September 2012, i.e. independent, simple and, if breached, trigger an immediate supervisory response.
- The concept of EWIs – or a non-modelled backstop – is also on EIOPA's agenda and the International Association of Insurance Supervisors (IAIS) is also developing similar measures.

Q26: The concept of EWIs makes a lot of sense – it is the automatic capital add-on in the event of a breach of the indicator that concerns me. Where does the PRA stand on this?
A26:

- Solvency II allows the firm to use an internal model to calculate its regulatory capital requirement. The automaticity – and the application of a capital add-on in all but exceptional circumstances – is aimed at not allowing the firm to release modelled capital until the reasons for the breach of the indicator are understood by the PRA.
- If the firm assesses that a model change will take the Solvency Capital Requirement below the EWI, the PRA encourages a dialogue with the firm's usual supervisory contact before any such model change is made.
- We have noted that there may be legitimate reasons for some firms to operate below the EWI, but we expect these to be the exception rather than the rule when we have properly calibrated indicators.

Q27: How do the EWIs relate to the IAIS initiatives – are they the same as the backstop?
A27:

- It's helpful to differentiate the phases of work on the IAIS.
    1. First, how is the high loss absorbency calculated for globally systemically important insurers (G-SIIs)? This is no mean feat, and there will be work that informs the second phase.
    2. Second is the quantitative element of ComFrame with a potential read-across between the approach for G-SIIs and internationally active insurance groups.

- The point at which the IAIS has the final quantitative element of ComFrame may be when the use of a backstop may be discussed. In this context, the backstop would relate to the frontstop of ComFrame, and EWIs would fit in at this point.

Trialogue discussions Q4, 2013

Q28: What is the PRA's opinion of the volatility adjuster agreed in trialogue discussions?
A28:

- It's too early to say what our opinion of the volatility adjustment is.
- The volatility adjustment has been agreed as a Level 1 measure. The detail, including its application, aspects of calibration and supervisory processes will be set out in the Level 2 text.
- When adopted as law, firms will have to justify against the criteria in the directive for why they would be applying the measure, and we would need to make supervisory judgements against those criteria.

Q29: How much guidance will the PRA provide to the UK insurance industry on Solvency II, for instance the interpretation and application of the matching adjustment?
A29:

- The PRA does not plan to issue significant amounts of detailed guidance to clarify its policy, whether in the form of general guidance issued publicly or advice given by supervisors to individual insurers.
- Where the PRA judges that guidance material is required, it will issue it in a Supervisory Statement.
- As Solvency II is a maximum harmonising directive, we expect there to be very limited areas for NCA optionality. Where these areas exist, the PRA's proposals will be consulted on through the usual process.
- Where the European policy text is ambiguous or unclear in the Level 1 or Level 2 text (i.e. the delegated acts and implementing technical standards), EIOPA may provide clarity in guidance.
- We are at the stage now where we can identify any areas that are ambiguous or lack clarity so that these can be raised during negotiations to create an operable regime on implementation in 2016.

Q30: How will the PRA apply the risk margin transitional floor?
A30:

- The PRA is currently considering the practicalities of applying the transitional floor. We consider it an important safeguard for policyholder protection.
- Transitional measures are intended to allow firms time to meet new regulatory requirements, to the extent that these represent an additional burden.
- The Level 1 text allows the amount of the technical provisions transitional deduction to be limited, to ensure that firms do not receive an inappropriate amount of transitional relief. In particular, the transitional deduction from Technical Provisions should be limited to the extent necessary to ensure that the firm's overall financial resources requirement (i.e. TPs plus capital requirement) is not more favourable under Solvency II than was the case pre-day-1.
- Our current intention would be to limit the transitional deduction in those cases where the Solvency II requirements would otherwise be lower than the ICAS requirements (or lower than Solvency I Pillar 1 requirements, where these are the binding constraint). In such cases, were the deduction not limited, firms using the transitional would see a *reduction* in overall financial resources requirement versus our current regime. We would intend to limit the deduction as far as was necessary to ensure that the overall financial resources requirement remained at least at its pre-day-1 level.
- The amount of the transitional deduction will in any case reduce linearly over the 16 year transitional period. Thus any limit to the amount of the deduction is only likely to be necessary during the early years of the transitional period.

Q31: Does the PRA have a view on how much the November 2011 draft Level 2 text will change?
A31:

- The Commission has expressed a desire for as much as possible of the agreed Level 2 text to remain untouched. This is a call to NCAs and the insurance industry too.

- It is important that the Level 2 text makes Solvency II operable for what is needed on day one of the new regime. As such, we think that there might be some changes – for instance the detail of the matching and volatility adjustments to be included in the Level 1.
- There is not a lot of time to 1 January 2016 and we currently expect a stable version of the delegated acts in March 2014, with implementing technical standards being produced in waves in the run up to transposition in March 2015.

Q32: The lack of clarity on the transitional arrangements present challenges to insurers – both from an operational and capital perspective. Does the PRA have any advice for firms?

A32:

- The advice to firms is to await the stable version of the delegated acts expected in March 2014 which will provide more clarity.

Open Q&A

Q33: Does Solvency II go far enough to address the potential for bad behaviour and cultures in insurance firms?

A33:

- Solvency II builds on the foundations laid by the Individual Capital Adequacy Standards (ICAS) currently operating in the UK. Through ICAS supervisors have reviewed firms' business models and plans, including how the business would respond to stresses and scenarios. In addition, the use of realistic balance sheets has informed pricing and product structures. The PRA also conducts governance and Board effectiveness reviews, part of which includes reviewing remuneration and incentives.

Q34: What is the PRA's approach for third country branches under Solvency II?

A34:

- Discussions are ongoing with the Commission – including with EIOPA – about particular legal considerations, including resolution regimes and equivalent policyholder protection. These discussions are not public at the moment and we expect clarity over the coming year.

Q35: Given the constraints on capital add-ons in Solvency II, could any shortfalls in regulatory capital be addressed through the provisions of Pillar 2, e.g. the ORSA?

A35:

- The ORSA cannot be used to set regulatory capital – that's prohibited under the Solvency II Directive.
- The ORSA can be used to identify the mitigation a firm might put in place to address certain risks.
- Capital add-ons do not relate either to Pillar 1 or Pillar 2. They are an input to the supervisory process whereby supervisors can use a capital add on where there are shortfalls in the risk management and/or governance of a firm, as well as the calibration of the Pillar 1 calculation.

Q36: What is your advice to those firms that aren't able to reach their supervisor or don't have a named supervisor?

A36:

- If you're unable to reach your usual supervisory contact, please contact the Insurance Directors – Andrew Bulley for Life Insurers and Chris Moulder for General Insurers.
- If the firm does not have a named supervisor, it can contact the Firm Enquiries Function at PRA.firmenquiries@bankofengland.co.uk or 020 3461 7000.