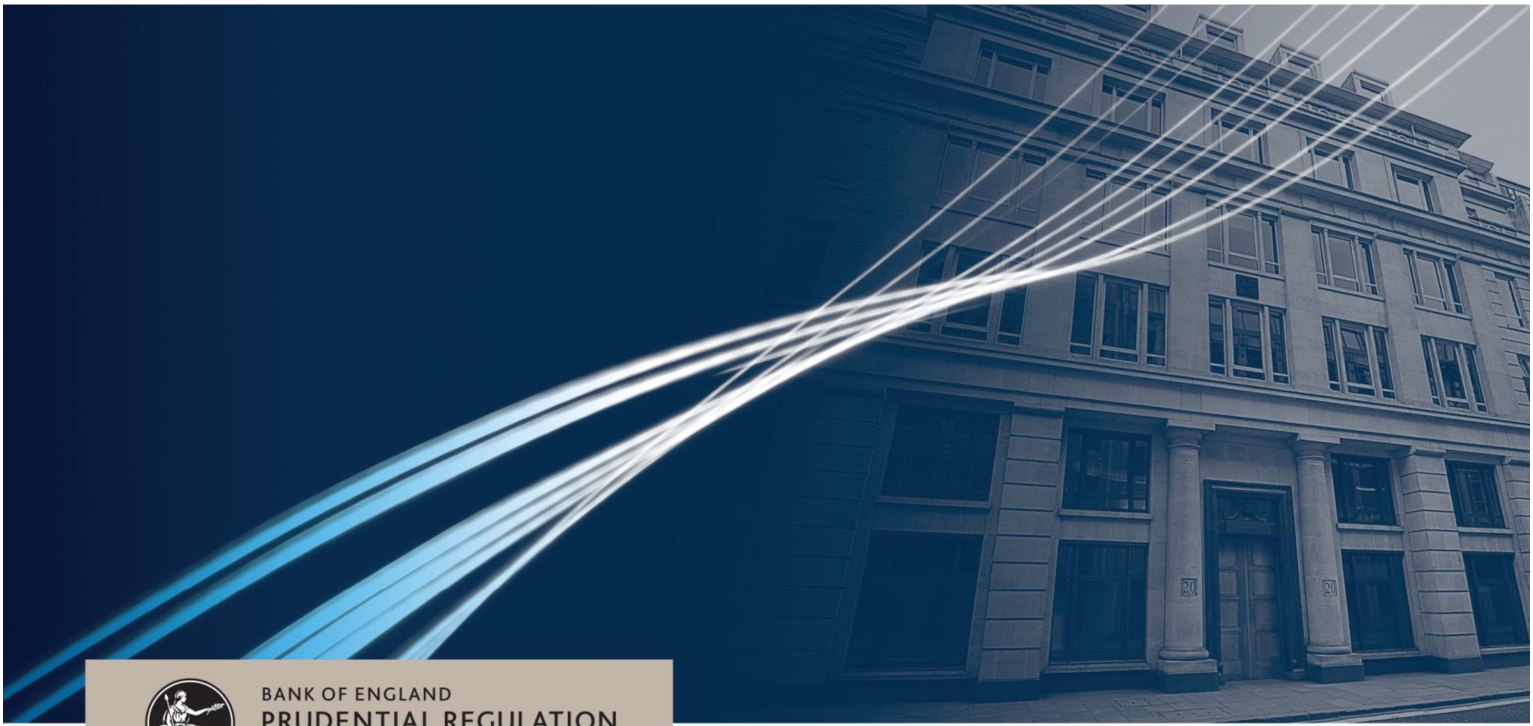

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP19/16

Solvency II: Changes to internal models used by UK insurance firms

May 2016

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Responses are requested by Friday 5 August 2016.

Please address any comments or enquiries to:
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1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) proposes a draft supervisory statement setting out its expectations on firms and the Society of Lloyd's in relation to changes to internal models[1] and extensions to the scope of internal models that have been approved under Solvency II.[2]

Background

1.2 Under Solvency II, the PRA may approve applications to use an internal model to calculate the Solvency Capital Requirement (SCR) and an internal model change policy. Under Regulation 48 of the Solvency 2 Regulations 2015 (2015/575)[3] (transposing Articles 112 and 115 of the Solvency II Directive) firms may apply to the PRA for supervisory approval of a major change to an internal model (as specified in the firm's approved internal model change policy), or for changes to the internal model change policy itself.

1.3 According to recital no.3 of the Commission Implementing Regulation (EU) 2015/460,[4] the inclusion of new elements in the internal model, such as additional business units or risks not included in the scope of the internal model, are subject to supervisory approval as laid down in Article 112 of the Solvency II Directive.

Purpose

1.4 This consultation is relevant to insurance firms with an internal model approval under Solvency II. It may also be of interest to UK insurance firms seeking approval to use an internal model in the future and also to UK subsidiaries of EEA or non-EEA groups.

1.5 The PRA is consulting on the draft supervisory statement to allow firms the opportunity to provide feedback and highlight any issues of concern.

Responses and next steps

1.6 This consultation closes on Friday 5 August 2016. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP19_16@bankofengland.co.uk.

2 Proposals

2.1 The proposals in this CP contain the PRA's expectations on firms in relation to: changes to approved internal models; changes to the approved policy for changing the internal model; and extensions to the scope of approved internal models.

2.2 The proposals describe the PRA's expectations of firms before and during a model change application (which covers any of the changes described in 2.1), the PRA's expectations of the quality of firms' model change applications, and the information the PRA expects to be provided with a model change application.

1 Throughout this CP the use of the term internal model will cover both full and partial internal models.
2 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and reinsurance (Solvency II) (recast). http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02009L0138-20140523.
3 www.legislation.gov.uk/uksi/2015/575/pdfs/uksi_20150575_en.pdf.
4 http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32015R0460.

3 The PRA's statutory obligations

3.1 The PRA has a public law duty to consult widely on any measure that significantly affects firms. In discharging its general functions the PRA must, as far as it is reasonably possible, act in a way that advances its general objective and its insurance objective. When discharging its general function in a way that advances its primary objectives, the PRA has, as a secondary objective, a duty to facilitate effective competition.

Compatibility with the PRA's objectives

3.2 The PRA believes that the proposals in this CP are compatible with the PRA's statutory objectives under the Financial Services and Markets Act 2000 (FSMA): to promote the safety and soundness of PRA-authorised firms;[1] and in the context of insurance, to contribute to policyholder protection.[2]

3.3 The draft supervisory statement is intended to give insurance firms greater clarity about the PRA's expectations with regards to model change applications under Solvency II. By providing guidance the PRA is seeking to support good governance, systems and processes, which will promote the safety and soundness of firms and contribute to the protection of policyholders.

3.4 The PRA has assessed whether the proposals in this CP facilitate effective competition. The new PRA expectations in relation to the quality and content of a model change application do not impose additional requirements, but clarify how the Solvency II requirements may be met, and therefore are not expected to have a material effect on competition.

3.5 In setting expectations for the model change application process, the PRA has had regard to the process used for the banking industry. The PRA considers the proposals, which are a consistent approach across the sectors where appropriate, to be compatible with the facilitation of effective competition.

Regulatory Principles

3.6 In establishing its practices and procedures, the PRA must have regard to the Regulatory Principles as set out in FSMA.[3] The draft supervisory statement is compatible with the Regulatory Principles as the PRA sets out transparent and proportionate expectations on firms in relation to Solvency II requirements. Setting out these expectations clearly also contributes to the efficient use of PRA's resources.

Cost benefit analysis

3.7 This cost benefit analysis compares, for the insurers in scope for Solvency II, the costs and benefits arising from the proposal set out in the draft supervisory statement.

3.8 The draft supervisory statement aims to ensure that there is a clear and consistent understanding of the PRA's review process for model change applications and the information expected as part of such an application by internal model firms or firms seeking approval to use an internal model in the future.

1 Section 2B (1) and Section 2B (2) FSMA.
2 Section 2C FSMA.
3 See s.2H and s.3B FSMA.

3.9 The PRA does not currently impose specific fees for model change applications. The PRA will keep this policy under review. Any proposals to amend this approach in future would be subject to separate consultation.

Costs

3.10 The PRA expects costs to be minimal to the extent that the proposals do not create additional requirements to those set out in the Delegated Acts and Implementing Technical Standards. The PRA's expectation of no more than one application per year is an expectation rather than a requirement and does not preclude firms from making more than one application in a year should business or market conditions require it.

Benefits

3.11 The Solvency II requirements became effective from 1 January 2016. The statement is intended to reduce the potential for firms to apply the requirements inconsistently.

3.12 Setting out the PRA's expectations regarding the content of a model change application is intended to enhance the quality of applications and therefore reduce the administrative burden for firms and the PRA.

Impact on mutuals

3.13 In the PRA's opinion, the impact of the draft supervisory statement on mutuals is expected to be no different from the impact on other firms.

Equality and diversity

3.14 The PRA may not act in an unlawfully discriminatory manner. It is also required under the Equality Act 2010[1] to have regard to the need to eliminate discrimination and to promote the equality of opportunity in carrying out its policies, services and functions. To meet its requirement, the PRA has performed an assessment of the proposals and has not identified any equality or diversity implications.

1 Section 149 (1) Equalities Act 2010.

Appendix - Draft supervisory statement – Solvency II: Changes to internal models used by UK insurance firms

1 Introduction

1.1 This supervisory statement is relevant to firms with an internal model approval under Solvency II.[1] For the remainder of this supervisory statement internal model should be taken to mean both full and partial internal models. This supervisory statement may also be of interest to UK insurance firms seeking approval to use an internal model in the future and to UK subsidiaries of EEA or non-EEA groups.

1.2 This supervisory statement sets out the Prudential Regulation Authority's (PRA) expectations in respect of firms applying for approval for a major change to their approved internal models (either an individual major change or major change triggered by an accumulation of minor changes) or an extension of scope to an approved internal model (eg to cover new business units or risks). This supervisory statement also sets outs the PRA's expectations in respect of firms applying for a change to their approved internal model change policy.

1.3 In the remainder of this supervisory statement the use of the phrase 'model change application' should be taken to mean any of these applications, unless otherwise specified.

1.4 In particular the proposed supervisory statement covers the:

- interaction with the PRA before and during a model change application;
- quality of a model change application; and
- the information to be provided with a model change application.

1.5 The PRA's approach to reviewing model change applications will have similarities to the internal model approval process (IMAP). It will form part of the PRA's overall approach in ensuring a firm's internal model continues to meet the Solvency II requirements and the Solvency Capital Requirement (SCR) remains appropriate for its risk profile.

1.6 The PRA will adopt the same supervisory approval process for: model change applications in respect of individual major changes; major changes triggered by an accumulation of minor changes; and extensions of the scope of the internal model (eg to cover new business units or risks). The applications to apply changes to the policy for changing the internal model will be subject to a standalone review process.

2 Interaction with the PRA before and during a model change application

Interaction with the PRA before a model change application

2.1 The PRA expects firms to engage as early as possible with their supervision teams about planned changes and developments to their internal models. This should include any model changes that may arise from expected future changes in the firm's risk profile, for example as a result of a potential business transaction. In particular, the PRA expects firms to give notice of their proposed model change application(s) as soon as firms consider an application likely.

1 As per Regulation 48 of the Solvency 2 regulations (2015/575).

2.2 When giving notice of a model change application the PRA expects firms to provide a summary of their planned model change(s), the reasons for the change(s), the potential impact (both qualitative and quantitative) and the intended timescales for implementation.

2.3 The PRA expects firms to discuss the scope of their model change application with their usual supervisory contact. The PRA expects model change applications to address past PRA feedback, past data audits, limitations of the model, improvements driven by ongoing use of the model,[1] validation findings and findings arising from the PRA's supervisory review process. In addition, the PRA expects firms to articulate clearly how they have identified and prioritised the model change(s) included in their application as opposed to other model improvements in their model development plan.

2.4 The PRA will discuss with firms whether it would be useful to enter into a pre-application review process before submitting a formal model change application. This is likely to depend on the complexity, scale and quantum of model changes proposed. The length of any pre-application will also be subject to discussion with the PRA and will reflect the extent of review work considered necessary. If firms choose to make use of a pre-application period, feedback would be provided by the PRA during this process; however, this is not a substitute for the firm's own internal governance or validation process.

2.5 The PRA expects firms - in most circumstances - to submit no more than one model change application per year. This application may comprise several individual major changes (and include any extensions of scope of the internal model) which will be reviewed together under the same supervisory approval process. This will help to ensure that firms are able to provide robust governance over model changes and that the PRA is able to commit appropriate resources to the review of the application. However, the PRA understands that there may be exceptional circumstances in which more than one model change application may be necessary in a year, for example due to new or unforeseen business transactions.

2.6 A planned transaction (for example an acquisition or investment in a new asset class), or other event, may lead to a change in the firm's risk profile, and therefore may instigate a model change application. In such situations firms should consider whether the model change application can realistically be approved by the time the transaction takes place. If the approval of the model change application is not expected to be obtained in time, firms should discuss with the PRA how they will ensure they will calculate the revised capital requirements and remain adequately capitalised after the transaction or event takes place.

2.7 Where an event occurs which causes a firm to consider whether changes might be required to its internal model, the PRA recognises that it might take some time for the firm to determine that changes are required and for these changes to be implemented within the model in a way which meets the Solvency II requirements. In such circumstances, the PRA expects firms to discuss with the PRA what other steps might be taken in the interim until a model change application can be made and a decision can be taken.

1 As per Guideline 11 (Incentive to improve the quality of the internal model) of the EIOPA Guidelines on the use of internal models.

Interaction with the PRA during a model change application

2.8 Once a firm has submitted a formal model change application the PRA will have 30 days[1] (or 45 days in the case of a group internal model)[2] to check that it is complete. The PRA has up to six months from the date of a complete application to provide a decision.[3]

2.9 Following the submission of a model change application firms should continue to use the current approved internal model for determining its SCR. This can include minor changes implemented within the current approved internal model, as long as these fall below the firm's threshold in respect of accumulating minor changes. Subsequent to the application of a model change the PRA expects firms to contact their supervisor when making minor changes to their model. The PRA will consider whether the minor change accumulations are reset at that point.

2.10 The PRA will regularly review firms' reporting of minor changes[4] and may challenge any that the PRA considers should be classified as a major model change. In addition, minor changes may be subject to review by the PRA at any time.

2.11 Firms are reminded that they should remain adequately capitalised at all times,[5] including the period when a model change application is being reviewed by the PRA. The PRA may consider use of supervisory tools (including as a temporary measure) to ensure that any risks are adequately mitigated.

2.12 In demonstrating ongoing compliance with the use test, firms are reminded to consider Guideline 12 (Use test and changes to the internal model) of the EIOPA guidelines on the use of internal models.

2.13 The PRA expects firms to have regard to the possibility that the model change application is not approved. In addition, the PRA expects firms to prepare for the possibility that accumulations of minor model change may need to be unwound should the subsequent model change application not be approved. Minor model changes may also be challenged as part of the PRA's ongoing supervisory review.

Changes to the policy for changing the internal model

2.14 The PRA expects firms to discuss with their supervisory contact their plans to change the policy for changing the internal model. This will require a separate application and this can be reviewed on a standalone basis by the PRA. However, firms may wish to align an application to change the policy for changing the internal model with an existing model change application.

3 The quality of model change applications

3.1 The PRA expects firms' model change applications to be of a high quality in order to improve the likelihood of it being deemed a complete application. If a firm's model change application is of poor quality, the PRA will discuss with the firm an alternative timescale for submitting a revised application.

1 As per Article 3 of the Implementing Technical Regulations.
2 As per Article 348 of the Delegated Regulations.
3 As per Regulation 48(4) of the Solvency 2 Regulations 2015 (2015/575).
4 As per Guideline 8 of EIOPA's Guidelines on the use of internal models https://eiopa.europa.eu/publications/eiopa-guidelines/guidelines-on-the-use-of-internal-models.
5 PRA Rulebook fundamental rule 2.4; PRA rulebook Solvency Capital Requirement – General Provisions rule 2.1.

3.2 Firms are reminded that the internal model, following model changes, must continue to meet the Solvency II requirements. This includes the requirement to meet validation standards and that the model change application is signed off by firms' boards prior to submission.[1] The PRA expects the model change application to include model outputs that include the effect of the model change.

4 The information to be provided with a model change application

4.1 The PRA's model change application form can be found on the Bank of England Website: www.bankofengland.co.uk/pra/Pages/authorisations/siiapprovals/applying.aspx.

4.2 The application form should be used in respect of: individual major changes, major changes arising from an accumulation of minor changes, extensions of the scope of the internal model and changes to the policy for changing the internal model.

4.3 Firms' major model change applications will need to include the information specified in Articles 2 and 7 of the Commission Implementing Regulation EU 2015/460 for internal models. This should include the following items of information described in Article 2 and 7:

(a) A cover letter requesting approval (of the model change(s)) and confirmation that the application is complete.

(b) The documents set out in Article 2 where their content would be affected by the major change, together with an indication of the changes made to them.

(c) A detailed description of the qualitative and quantitative impacts of the major change to the approved internal model and its results.

(d) Documentary evidence setting out how the internal model fulfils the relevant internal model tests and standards.

4.4 In order to assist the PRA with the review of the model change application and provide evidence that the internal model continues to meet the Solvency II internal model test and standards the PRA expects it will be useful for firms to provide the following:

(a) Justification for the model change(s).

(b) A description of the changes that have been made from the latest approved model.

(c) A log containing a record of planned and historic changes to the internal model.

(d) Evidence that the model change application has been signed-off by the board.

(e) Evidence that the model change(s) have been independently validated.

(f) An updated Common Application Package (CAP) indicating clearly which items of evidence have changed since the version of the model last approved by the PRA.

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1 PRA Rulebook Solvency Capital Requirement – Internal Models rules 7.1, 14 www.prarulebook.co.uk/rulebook/Content/Part/212824.

4.5 Applications in respect of changes to the policy for changing the internal model firms will need to include the information in Article 8 of the Commission Implementing Regulation EU 2015/460 for internal models. This should include the reason for the change of the policy for changing the internal model and evidence that, after applying the changes, the requirements to approve this policy would be met. In order to evidence this it would be helpful if firms back-tested their new policy in order to justify any changes in the thresholds used to classify major changes.