BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Speech

PRA Solvency II Conference: countdown to implementation

Speech given by
David Rule, Executive Director, Prudential Policy

At the PRA Solvency II Conference, London
17 October 2014

I would also like to extend my welcome and thanks to you for taking the time to attend this conference today. I want to take this opportunity to formally introduce myself. I was appointed Executive Director of Prudential Policy at the Bank of England in June having held a variety of different roles across the Bank and FSA, most recently as a supervisor of large UK banks.

This conference is entitled 'countdown to implementation'. We have reached a level of stability in the policy making process for Solvency II, and the purpose of today is to share our thinking and provide clarity where possible on those last remaining issues ahead of implementation. You'll be hearing from experts across the technical areas and Victoria Saporta, Director of Financial Policy will give you an overview of the policy areas where work is still being finalised along with the timeline for completion.

I would like to take a step back from this and reflect more widely on what Solvency II is about for the Bank.

To echo the Governor's words from his speech to the Institute and Faculty of Actuaries in September "Insurance is at the core of the new Bank of England"…we have over 200 supervisors and 50 actuaries engaged in the implementation of Solvency II, not to mention the contribution from numerous dedicated policy experts. In addition, with insurance supervision now embedded in the Bank, supervisors benefit from the support of monetary policy experts, credit risk analysts and macro-financial analysts.

The insurance sector plays a key role in the financial system and the economy. It protects companies and individuals from perils they could not otherwise shoulder, managing and spreading risk globally. Insurers are vital to efficient allocation and overall provision of capital, they provide alternative sources of funding, increasing the diversity in the system.

The PRA has two primary statutory objectives: to promote the safety and soundness of all banks, insurers and major investment firms and, a specific objective for insurers, of contributing to the securing of an appropriate degree of protection for policyholders.

These objectives are the guiding principles that ultimately underpin our implementation of Solvency II. The core objective of the new regime is greater policyholder protection.

Solvency II is a welcome modernisation of European regulatory standards. You will be familiar with the UK's ICAS regime. Solvency II recognises many of the principles that form the basis of that regime, and therefore introduces a level playing field with the rest of the EU. Risk-based capital standards and robust valuation practices ensure resilience against unexpected losses. The enhanced disclosure rules in turn aim to encourage the effective exercise of market discipline through increased provision of information. Our approach to third country branches will aim to ensure that they are operating to standards that give branch policyholders an equivalent level of protection to policyholders of an EEA-headquartered undertaking.

The three pillars of Solvency II not only provide a robust foundation to support the safety, soundness and resilience of individual insurers, but also in turn support stability in the system.

The financial services sector is more interconnected than ever before. Risks to the financial system can affect all firms; we therefore need to ensure that our analysis is rigorous not just within sectors but at a cross-sectoral level. With a number of mixed financial groups undertaking insurance, banking, asset management and any number of other activities in multiple locations across continents, it is vital for firms and regulators alike to understand the interconnections and dependencies not only between different firms but within them as well.

This is just one reason why it is so crucial to get the new regime right. The introduction of consolidated group supervision under Solvency II will ensure supervisors and firms have greater clarity in their overall view of group business, and are able to recognise and therefore manage risks that would not otherwise be visible. In particular, we will be able to look across groups to ensure that they have adequate resources, even if risks are being transferred to group companies located in countries with different regulatory regimes, such as offshore centres. And we will be alert to regulatory arbitrage, such as where risk transfer through reinsurance is negated through sliding scale commissions.

The financial crisis, and the post-crisis regulatory reform agenda, have taught us many lessons. The business models of insurers and banks are different, but those lessons have informed and will continue to inform how we manage the implementation of Solvency II.

Perhaps most salient for this conference, is the difficult lessons we have learned from experience with insurers and banks when it comes to the use of internal models. Many of you in this room will be acutely aware of the demands of the Solvency II model approval process. This rigour has a purpose. Use of internal models can be an effective means of harnessing the better knowledge a firm has of its own risk profile to set risk-sensitive capital requirements. But there are limits to our ability to model capital requirements. These are more acute where the event – for example, a credit default or a windstorm – being modelled happens infrequently and historical data is therefore scarce, where events cluster rather than occur independently or where the underlying process behind the event – for example the structure of the economy or the natural environment – may have changed, so that history is an unreliable guide to the future. In such circumstances, significant uncertainty about model outputs may call for a more prudent approach. And the temptation to add additional parameters, making models more and more complicated, can often have the perverse effect of weakening model performance. This is why, in addition to scrutinising the technical components of models, we also look at the way they are used within firms. Only a good model can play an important role in a firms' system of governance. Our expectations of their quality are high as Solvency II specifies that they become an embedded part of the risk management system of a firm. It is therefore not only important for us to rigorously assess them but that senior management have ownership of these models and continuously do the same. The Bank of England takes model approval very seriously indeed and we will not hesitate to hold back approval for the use of models where there are risks that cannot credibly be modelled or data are insufficient.

Throughout the implementation of Solvency II, we have worked hard to ensure that progress in the regulatory agenda is not synonymous with unnecessary impediments on your ability to grow and evolve your businesses. At all times, though, insurers must be capitalised to deliver policyholder protection, and this must be commensurate with the risks they take.

A priority in this area is the revitalisation of robust securitisation markets in Europe, many of which have yet to recover from the crisis. We have been working with the ECB and other European authorities with the goal of encouraging securitisation as a means for lenders to diversify funding and reduce concentrations – but not to arbitrage capital regulations. A growth in 'real money' investors, such as insurers, will increase the diversity of funding providers to the real economy, avoiding the pre-crisis reliance on an unstable, leveraged investor base.   A key goal is to improve transparency, simplicity and consistency so that investors can understand the risks associated with securitisations. For simple, transparent and consistent securitisations, we are prepared to review whether post-crisis regulatory requirements for investors and originators are too onerous.

That includes Solvency II, where we welcome a recalibration of capital requirements for such simple, transparent and consistent securitisations, particularly at longer maturities. The ongoing participation of insurers – a major source of long-term finance – in this debate will be key to achieving results.

We have got to a stage now where the path to Solvency II is clear. We have come a long way from the uncertainty that has seemingly dominated the past few years. But we need to remain conscious of the new challenges and opportunities that are on our horizon.

Alongside the European process the wheels have been turning in the international space. A common set of global standards for systemically important insurers are being worked on as we speak.

Throughout the development of these standards, the Bank of England will continue with its strong history of international engagement. We have made great strides in Europe with Solvency II and we aim to ensure the complementarity of upcoming global standards with what we have achieved with Solvency II.

Continued interaction with the industry is an essential part of good policy making so I'd like to again thank you for your participation today. I hope that we can continue to work together towards achieving a policy outcome at all levels that fulfils our objectives and in turn ensures the stability, resilience and ultimately the prosperity of the insurance sector in the UK.