BANK OF ENGLAND

Speech

Reflecting on Solvency II: continuity and change

Speech given by

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At the European Insurance conference

2 June 2015

It is a great pleasure to be invited to speak to you today.

Your invitation to speak is a timely one. 2015 is both a momentous and an exceedingly busy year for the insurance industry because it sees the final, much heralded, and undoubtedly long-awaited implementation of Solvency II. But at the same time, the industry is responding to a bracing business environment, and the on-going challenge of achieving acceptable yield in a low interest rate environment and operating within the 'soft' period of the cycle.

I would like to focus on the remaining path to Solvency II. I do so with a sense of satisfaction as to what has been achieved by industry and regulators alike. On the eve of what is a once in a generation reform of insurance regulation across Europe, I want to reflect on some things that will, and will not, change under Solvency II.

Despite the increasingly hectic pace of implementation, it is essential not to overlook the strong elements of continuity that are also present within Solvency II. Indeed my theme today is how Solvency II combines continuity and change: continuity with many aspects of our existing regime of prudential insurance supervision, which I believe has served the UK well since it was framed in response to the 2001-03 bear market; and change – and undoubtedly change for the good – in terms of the way Solvency II will, by design, raise standards of risk management, heighten board and senior executive understanding and use of capital models, and widen reporting and disclosure to the regulator and the market.

We have just under seven months until Solvency II is fully operational. Like me, insurers are no doubt noticing a marked shift in activity from the theoretical to the practical.

Solvency II - continuity

The UK introduced the Individual Capital Adequacy Standards (ICAS) regime for insurers in 2004, as a determined policy response to the experience of the 2001-3 bear market and the pressures created for with profit funds by the fall in nominal interest rates, which manifested themselves most visibly in the problems at Equitable Life. Almost uniquely in Europe, the UK has been operating an economic capital regime for insurance regulation for more than ten years.

The ICAS regime has many parallels with the Solvency II framework; and for that reason the transition to Solvency II from the current ICAS regime should be seen as 'evolutionary', not 'revolutionary'. In short, we are transitioning from a solid and advanced starting point.

Since 2004 the UK has operated a capital regime requiring insurers, both in the life and GI sectors and across the London market, to meet capital requirements at the one in two hundred confidence level. That confidence level calibration also lies at the heart of Solvency II.

Furthermore, as part – and I would argue as a virtue – of the ICAS regime, the UK already has a decade's experience of working to a market-consistent valuation basis. Solvency II is founded on this same philosophy that the value attributed to a firm's assets and liabilities in the regulatory balance sheet should broadly reflect the current value at which they can be traded in financial markets; and that, underpinned with appropriate requirements on systems, controls and governance, this valuation method contributes to a firm's understanding of risks.

But leaving these technical comparisons aside, both the ICAS and Solvency II regimes are about far more than constructing a capital requirement number – important though that is for people in my profession as much as in yours! A founding inspiration of the ICAS regime is that the regulatory framework should encourage firms to identify their own risk appetite and risk profile, and enable these consciously to drive capital deployment within their business model.

A pivotal aim of ICAS, and one that is entirely shared in Solvency II, has been to improve the risk-management culture within firms. In my eleven or so years in insurance supervision, I have observed UK insurers, both life and general, make major strides in this regard. Firms' boards and senior management have increasingly used the Individual Capital Assessment as a key decision-making tool, whether in setting overall strategy, considering M&A possibilities, or allocating capital to business lines. But more can be done – and will be done under the fresh impetus of Solvency II.

There is, however, a golden thread of continuity running through the fabric of our present regime and Solvency II, namely the protection of policyholders. Although achieving a level market playing field and promoting the cross border provision of services across Europe are important parallel objectives of the Directive, there is no sense in which these override policyholder protection. Indeed, Solvency II states unequivocally, and I quote the Directive directly here: *"The main* *objective of insurance and reinsurance regulation and supervision is the adequate protection of policy holders and beneficiaries."*

I must emphasise also that we shall continue to adopt a supervisory approach that takes forward this objective. Reflecting lessons often learned the hard way during the financial crisis, the PRA's supervisory model is strongly forward-looking, risk-based and judgement-led. These principles are consonant with, and embodied in the objectives of Solvency II's supervisory review process.

Consequently, as now, our supervision will reflect the specific business model and risk profile of the firms in question. And through careful supervisory judgement we will ensure that a suitably flexible and proportionate approach is followed, in which supervisors consciously adjust supervision to the individual risk profile of each firm in turn.

I talk of continuity and the parallels between the current ICAS regime and Solvency II. However, I would highlight that our transition to Solvency II, for which we have been planning and preparing since at least 2007, took a major leap forward in 2013 when we introduced the concept of "ICAS+".

At that time negotiations on the Directive had stalled and indeed there was uncertainty whether it would even happen. In response, to meet both regulatory requirements and enable firms to achieve some return on their heavy investments in Solvency II, the UK opted to allow firms to use the internal models being developed for Solvency II to calculate present requirements under the current regime, so realising the benefits of modelling earlier on in the preparatory phase. I believe that this was a bold and pragmatic regulatory decision that has served the sector well; in time, people looking back on the history of Solvency II implementation in the UK will view ICAS+ as the crucible in which much of firms' practical implementation of Solvency II was forged.

I have discussed the elements of Solvency II which represent continuity. However, I would not want you to leave this conference today thinking that Solvency II is simply ICAS re-packaged and re-branded. Most importantly, thinking and developments in insurance capital modelling have come on hugely since the ICAS regime was first introduced: as a stylised fact, the capital models being developed for Solvency II can typically be 100 times or so more complex than their ICAS counterparts. I make this observation in a neutral way since complexity in itself is not a virtue. But given such a step up in modelling sophistication and scope, the case for an updated regulatory framework approach is, I believe, an unassailable one, and one that should be evident to all.

Solvency II – change

Firstly, let us look at the position from an EU-wide perspective. The new regime will harmonise an EU framework that has, over time, become disjointed, with at best sporadic use of economic capital measurement. Prudential regulation of insurance companies across Europe has existed since the 1970s but its evolution has been iterative in nature, resulting in a veritable patchwork of rules and regulations.

Solvency II addresses this head on, through replacing the existing national regimes with one, consistent and coherent Rulebook transposed into national law.

This is a formidable accomplishment, one that culminates more than a decade of laborious negotiation but also one with sizeable benefits: having a single solvency regime applied across the EU will establish a level playing field and so undoubtedly help promote the single market in insurance. For the wider market, this will mean enhanced visibility and increased comparability between individual firms within the EU.

Solvency II is, however, much more than a revised capital regime. Central to its purpose is the improvement of firms' risk management analysis and systems and, equally importantly, boards' understanding of risk and use of capital models in business planning and decision-taking.

A fundamental change is that supervisory authorities are no longer approving or setting a capital number, but are instead approving the model itself that produces a number. This is a decision of far reaching importance and, accordingly, the Directive rightly sets high thresholds, embodied in discrete tests and standards, which must be met across the piece if a model is to receive approval.

One of the requirements hard coded into Solvency II is that the internal model must be demonstrably understood and used as a business tool within a firm's governance and risk management. This is the Solvency II "use test". The inspiration behind this requirement must indeed be obvious. The last thing we or the architects of Solvency II want is models to operate as 'black boxes' wholly impenetrable to those outside the actuarial department and perhaps barely penetrable to many within it.

So as part of the use test, there is a clear duty on firms to demonstrate to the regulator that members of the board and all other senior executives involved in running the firm have an adequate understanding of the model. But here I want to engage in some "myth busting" and dispel some particular stories, which I am sure are apocryphal, that I hear now and again in my travels around the City. Let me say definitively that we are not expecting all board members to understand the intricacies of the Gaussian copula. To my mind, a firm distinction needs to be drawn in the following way: understanding and 'using' the model in decision making is distinct from being a technical modelling specialist.

We expect the internal model to be designed and operated such that it is a meaningful and effective risk management tool at all levels, not just for those who work day-to-day on the model's development and inner workings. The internal model should facilitate a greater understanding of the impact and risks involved in decision making. For this reason, it should be intelligible to a wider range of people. The board will comprise different levels of understanding and this is to be expected, indeed, encouraged; we would of course expect the FD and CRO to have a deeper understanding than a board member responsible primarily for, say, customer services or HR.

In general, we would expect executives to have a more detailed understanding than non- executives; and we look to the executives to ensure that their non-executive colleagues are adequately trained and informed about all aspects of the model. Amongst the non-executives we would expect the Chair and member of the Risk and Audit Committees to have a more detailed understanding than board members who do not sit on these committees. But we would expect all board members, both individually and as a collective unit, to be rigorously inquisitive, critical and challenging of the model, regularly questioning the outputs through addressing themselves to such vital issues as:

- What are the strengths of the model?
- Conversely what are the limitations?
- What are the fundamental and most sensitive modelling assumptions and judgements being applied and what are the debates and alternative approaches surrounding them?
- How far does the capital "dial move" if we change these assumptions and judgements?
- On the "garbage in, garbage out" principle, are we satisfied with the accuracy, scope and integrity of the data feeding into the model?

In addressing questions of this nature, board members should rightly expect comprehensive support from the wider business, and from the independent internal validation process Solvency II also requires, to ensure such key matters are explained in a way that the Board can properly comprehend and engage with.

Gaining internal model approval is, however, only the start. We are acutely conscious of the risk that model integrity deteriorates over time or that, post approval, key model assumptions or calibrations are adjusted imprudently. For that reason, Solvency II applies stringent requirement on model change policy and disclosure. There is an unequivocal onus on firms to recognise where a model change is required or has occurred and to look across several quantitative and qualitative indicators in this regard, which the PRA will also be monitoring closely. In particular, firms should not overlook the impact that an accumulation of small or incremental changes could have on the overall model output.

Other Solvency II approvals

I can understand why, when listening to a talk such as this, it is easy to form the impression that Solvency II is about model approval and little else. But important though it is, in the UK internal model approval is one of no less than 19 separate Solvency II approvals that firms can apply for.

Indeed, there may be dependencies between a firm's Solvency II approval applications. For example, and again in common with ICAS, Solvency II recognises, in the form of a specific capital calculation benefit, the liquidity premium that firms such as annuity providers with highly illiquid and predictable liabilities are able to earn on their investment portfolios. Under Solvency II this is known as the matching adjustment and, separately, the volatility adjustment. It is possible that a firm may wish to use the matching adjustment for some of its business, but to use the volatility adjustment as a contingency option. In this situation, the PRA will consider matching adjustment and volatility adjustment applications in parallel. I should stress, however, that to receive a parallel review, firms must make clear in their applications which is the preferred measure, and which is the alternative measure. To minimise the administrative burden on all parties, we will try to schedule review work so as to reach a 'joint decision' on the two approvals concurrently and communicate the result simultaneously.

A question many of you may ask is why have an approval process at all for these non-model specific adjustments? My response to this is the significance of the solvency benefits these adjustments can rightly bestow and hence the need for clarity and certainty on the regulatory stance towards their application firm by firm.

To take an example, the UK decision to operate a pre-approval process for the volatility adjustment is a relatively recent one. Operating an approval process allows firms to prepare for Solvency II. The approval process allows firms to know, sooner rather than later, whether an adjustment is allowable, so permitting firms to put into action 'Plan B' if necessary.

The alternative to a pre-approval process is a retrospective supervisory decision which could see firms being obliged to unpick their plans, ex-post. That is plainly undesirable: through pre approval firms and the wider market are afforded a greater level of certainty.

Let me say a few further words about the volatility adjustment, which is a significant innovation under Solvency II. The volatility adjustment is an addition to the risk free discount rate used to calculate a firm's best-estimate liabilities. As an addition to the risk-free rate, it reduces the value of a firm's liabilities. It is designed to counter the impact of 'excessive' market volatility in credit spreads and to prevent pro-cyclical investment behaviour. Unlike the matching adjustment, the volatility adjustment does not have strict asset eligibility criteria, matching or portfolio management requirements.

The prudential effect of granting the use of the volatility adjuster is that it leads to a reduction in the value of a firm's best-estimate liabilities. The key thing for the firm and the regulator to consider is whether using the adjustment is appropriate, given the nature of the underlying liabilities. It many cases, where obligations to policyholders are long-term and predictable, use of the adjustment will indeed be justified. But many insurance liabilities are unpredictable and cause the insurer to realise assets to meet claims as they fall due. In these circumstances, the volatility adjustment is clearly not appropriate, because the insurer faces the full range of credit, market, and liquidity risks on the assets it needs to sell in the market. The firm and the regulator need to have a clear view of when this is the case.

The ORSA

Risk based regulation has become a bit of a mantra, whether under ICAS or Solvency II. But that should not detract from the step up that Solvency II brings here. Yes, the UK operates a risk-based regime at present, but Solvency II takes that one step further, particularly in bringing to the fore the interplay between risk and capital. A case in point is the introduction of the Own Risk and Solvency Assessment (ORSA) – a tool that by design marries risk and capital, so ensuring they are not considered in isolation. It is, I think, a mark of the inherent value of the ORSA that it is being adopted by several jurisdictions, for example Canada and South Africa, that are not part of Solvency II.

Regulatory capital requirements may not adequately capture certain unquantifiable risks. Furthermore, firms face long-term and emerging risks, which may not appear significant over a one year time horizon, but over the longer term have the potential to be substantial. By requiring a firm to consider these longer term issues and non-quantifiable risks, the ORSA will help firms, regulators, policyholders and commentators better understand the risk exposures and the adequacy of firms' mitigation strategies and action.

Group supervision

In one respect, and one respect only, ICAS did not quite reach the aspiration of its original architects and that was because in practice it has developed mainly as a tool for the capital measurement of UK entities rather than a group wide measure: ten years ago introducing a Pillar II economic capital measure was a major step; extending this systematically to subsidiaries beyond the UK was, at that time, a step too far. But I am pleased to say that Solvency II is now taking this important step in a way that fully aligns the group supervision regime with the economic realities.

Insurance groups can be, and often are, multi-faceted in composition, consisting of regulated and non-regulated, financial and non-financial entities. Risk exposures of the group, in its entirety, can look rather different as compared to how they might appear at an individual insurance firm. For example, double use of capital and contagion threats can be more easily identified if group supervision is conducted on a consistent basis with a clear line of sight on the risk profile of the group as a whole.

Solvency II introduces consistent group supervision across EEA member states, supplementing solo supervision and providing a comprehensive view of where within groups the risks to the prudential soundness of solo firms lie. The regulatory college is a key device for dialogue between the national supervisory authorities. These colleges have already been playing a vital role in the Group model approval process. I am confident that Solvency II's group supervision arrangements will help foster an open, cooperative approach to group supervision across different geographical locations.

The improved assessment of group capital under Solvency II is, I think, of the way that the new regime improves the assessment of capital resources in general. We often focus on capital requirements, but the quality of capital covering those requirements is equally important from a policyholder's perspective. If capital instruments are insufficiently loss-absorbent, then a firm will not be able to meet its obligations as they fall due even if notionally it holds what is deemed to be a sufficient amount of capital. The focus on loss-absorbency, duration, availability and composition of capital resources is a welcome aspect of the new regime.

Disclosure

Let me turn finally to a subject which I imagine will be of more than passing interest to my audience today, that of disclosure. The over-arching point to emphasise here is that, for the first time, we will have an insurance capital regime across Europe whose reporting and disclosure requirements have been introduced with the express aim of improving the availability of information to the market. Indeed that is why, collectively, these requirements are known as the" third pillar" of the Solvency II regime.

Within the UK we have had a long tradition, dating back to the early 1980s, of disclosing the Pillar I "statutory" returns on the "freedom through disclosure" principle that this would foster market discipline and enable policyholders and their advisors to make informed investment choices. But because ICAS is an individual guidance regime, firms have not generally been able to disclose their Pillar II capital guidance. And while the IGD has been disclosed, and served as a basis for comparison between insurance groups, this is essentially a consolidation of statutory solo capital measures and so is largely non-economic and non-risk sensitive.

Solvency II changes all this.

Under Solvency II, firms' reporting to the regulators will experience a step change both in terms of content and frequency. But in addition, a much wider scope of information and data will be publically disclosed for the first time. The improved quality and greater quantity of firm disclosures under Solvency II should improve market participants' understanding of an insurer's business model and risks, thereby strengthening market discipline. For the very first time, *you* will be able to see insurers' economic capital reporting data, with elements such as the matching and volatility adjustments clearly identified and the output of models disclosed.

Insurers will henceforth publish a solvency and financial condition report ("SFCR"). In the SFCR, firms will be required to disclose any non-compliance with the SCR, and to explain the causes and consequences of non-compliance, in addition to measures taken to resolve the breach. This is a big step forward in achieving for greater transparency.

Importantly, this information will be disclosed on a consistent basis across the EU, upholding comparability and market discipline. Insurers, investor, analysts and supervisors alike will all be working to the same page. This is a fundamental advantage of Solvency II, driving markets across the EEA up to the same standards.

Greater transparency of the assets that insurers hold is of great benefit to market participants, but what of the insurers themselves?

Solvency II rests ultimately on the principle that firms understand and consider in depth their risk exposures on an economic and market consistent basis and hold capital commensurate with those risks, whether calculated through a standardised formula or an approved model.

To be clear, the responsibility and choice of what assets a firm invests in rests solely with the firm's management. Solvency II is impartial in this regard. There are no caps, parameters or investment limits. Instead, we will have flexible and judgement-based principles. In place of formal quantitative limits, Solvency II enshrines what is known as the prudent person principle, which places a responsibility squarely on the insurer to judge what investment best fits the risk profile of the organisation; it is for the regulator to satisfy itself as to the appropriateness and prudence of that judgement, bearing in mind the overall standards and calibration requirements of the Directive. Better quality data means supervisors can better understand the business models of the firms we regulate and in turn allows us to do a better, more informed job. But this does not mean that regulators will be running the show. It is, and will remain, for those running the business to determine which assets fit the business strategy and meet its policyholder protection obligations.

In this regard, the spotlight has recently fallen on insurers' investments in infrastructure assets. There has been a growing policy initiative within the UK and across Europe to consider the relative costs and benefits of insurers investing in infrastructure, recognising the need for such investment, the trend for banks to withdraw from their participation in this market, and the role of insurers as mobilisers of illiquid savings into relatively illiquid asset categories.

Investments in infrastructure projects can be attractive to insurers, particularly for annuity writers given their illiquid liabilities. But such projects can present idiosyncratic risks that are not suitable for traditional portfolio level management alone. From a supervisory perspective, we are neutral on the question of whether insurers should increase their exposure to infrastructure investments. Our concern is to ensure that the insurer is adequately capitalised relative to the risks it is running, and – importantly – is able to understand and control those risks. This includes having reliable information and data as well, of course, as expertise in the investment sector concerned. Judged against these yardsticks, I see that much in Solvency II that will help inform insurers' decisions on whether to invest in infrastructure. But we shall continue to review the evidence as the new regime beds down.

I have talked about the principles of Solvency II and what will and will not change. However, many of you will be less concerned with theory of Solvency II and more interested in its application. With only six full moths remaining before Solvency II comes into force, you will not have long to wait in this regard. I understand that Solvency II brings with it many challenges for insurers, all at a time when several environmental factors are also coming into play. For that reason the PRA will continue its close dialogue with firms in the run up to Solvency II and beyond.

But let me reiterate my strong confidence that, essentially because of what the regulators and the firms have together achieved under the ICAS regime, not least perhaps in weathering the worst financial crisis in living memory, the UK insurance market is in a strong position to implement Solvency II, achieve its core objective of policyholder protection, and make great strides in introducing a risk-based, transparent regime. For its part, the PRA will continue to work closely with the industry as this process of continuity and change steadily unfolds.