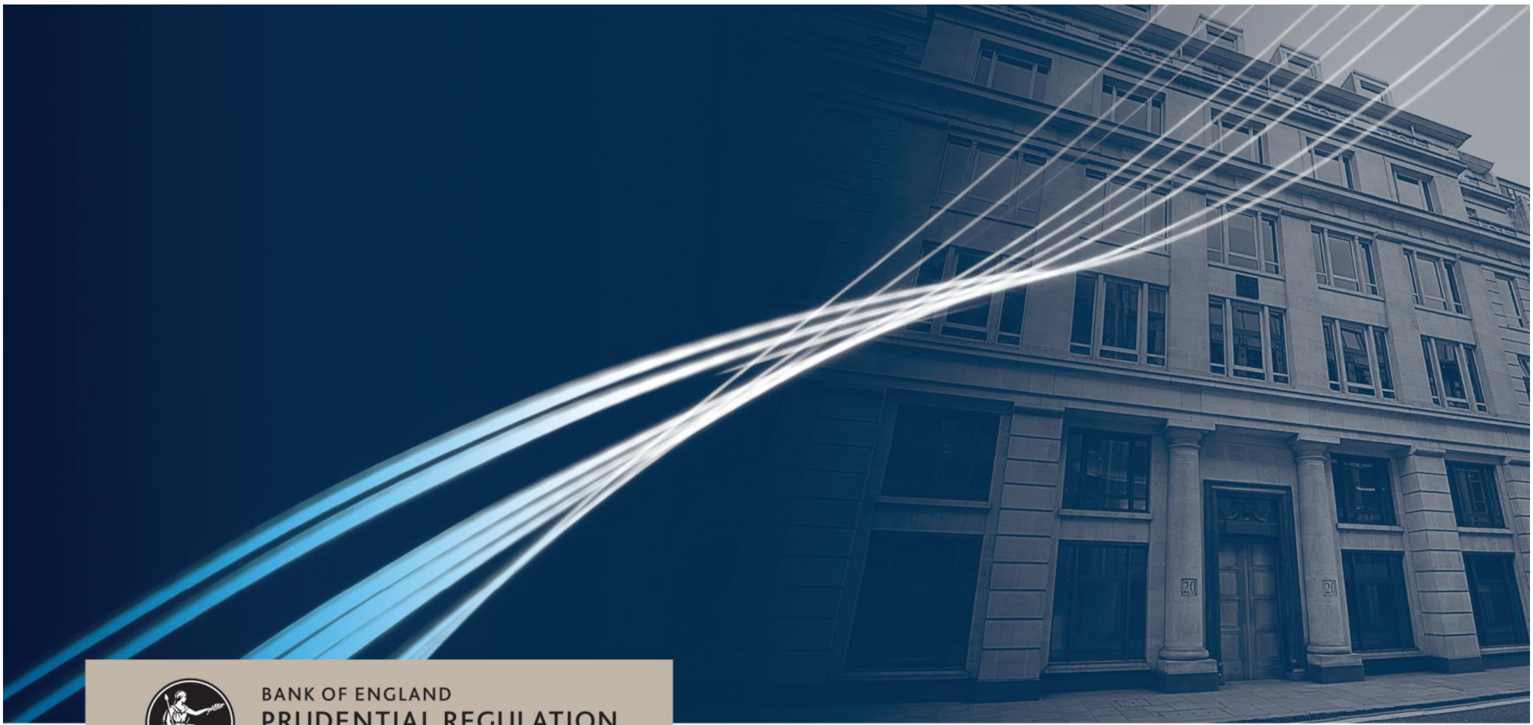

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Consultation Paper | CP22/16

Solvency II: Monitoring model drift and standard formula SCR reporting for firms with an approved internal model

May 2016

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Responses are requested by Wednesday 17 August 2016.

Please address any comments or enquiries to:
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Contents

1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) proposes a supervisory statement setting out the PRA's approach to monitoring model drift and expectations on firms with an approved internal model for the reporting of standard formula Solvency Capital Requirement (SCR).

1.2 As part of the PRA's proposed approach to monitoring model drift, the supervisory statement sets out an expectation that firms with an approved internal model should privately report their standard formula SCR information on an annual basis. A template is provided, which the PRA considers would make it simpler for firms to provide the information.

1.3 The CP is relevant to all PRA regulated solo insurance and reinsurance undertakings within the scope of Solvency II which have approval to calculate their solo SCR by internal model (this includes undertakings where the solo SCR is calculated by a group internal model), and to the Society of Lloyd's in respect of each of their syndicates and in respect of outputs of the Lloyd's internal model. The PRA may also request information at group level, and firms would be notified of this request via their supervisory contact.

2 Background

2.1 The Solvency II Directive includes a provision that, where relevant, the SCR be calculated using an internal model that has been approved by the supervisory authority. This may create some risk that as models evolve over time, capital levels may drift downward and fail to adequately reflect the level of risk in the system. The PRA is proposing an approach to monitoring this risk at the level of individual firms, for sectors and the industry as a whole.

2.2 These proposals should be read alongside PRA Supervisory Statement 25/15 'Solvency II: regulatory reporting, internal model outputs'.[1] The proposals set out in this CP would enable the PRA to monitor changes in internal model results against measures that are external to the internal model.

Proposals

2.3 The purpose of the proposed supervisory statement is to set expectations on internal model firms to report results of their standard formula SCR calculations to the PRA. The PRA proposes to use this information to monitor potential model drift. This includes the monitoring of the internal model SCR against objective measures of risk. These measures of risk, which may change over time, include the standard formula SCR, pre-corridor Minimum Capital Requirement (MCR), net written premium and best estimate liabilities.

2.4 The PRA proposes to calculate model drift ratios from the point of model approval and re-base following a change in risk profile or major model change. This approach would ensure that any drift is identified consistently and monitored over time.

2.5 The PRA does not intend any automatic supervisory action in response to any change in model drift ratios. However, changes may lead to a supervisory review to investigate the reasons for such changes.

1 PRA Supervisory Statement 25/15 'Solvency II: regulatory reporting, internal model outputs', June 2015, www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss2515.aspx.

2.6 As mentioned above, one measure of risk is the standard formula SCR. The proposed supervisory statement sets out an expectation that firms with an approved internal model should report the standard formula SCR information on an annual basis, in line with the European Insurance and Occupational Pensions Authority's (EIOPA) annual reporting timescales. A template, which will make it easier and simpler for firms to supply the relevant information, is included as an appendix to the proposed supervisory statement.

2.7 The Solvency Capital Requirement – Internal Models 3.4 part of the PRA Rulebook[1] states that, upon request, firms with internal model approval must provide the PRA with an estimate of the SCR determined in accordance with the standard formula. To comply with the rule all firms with internal approval must at all times maintain the ability to calculate their standard formula SCR.

2.8 The proposed supervisory statement states that firms may submit accompanying documentation with their standard formula SCR calculations to explain why the prescribed standard formula SCR calculation would be materially inappropriate to use as part of the model drift monitoring approach. This supporting documentation may include reference to alternative calculations as suggested by the firm.

3 Responses and next steps

3.1 This consultation closes on Wednesday 17 August 2016. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP22_16@bankofengland.co.uk.

4 The PRA's statutory obligations

4.1 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.

Regulatory principles

4.2 In developing the draft supervisory statement, the PRA has had regard to the regulatory principles as set out in the Financial Services and Markets Act 2000 (FSMA).

4.3 The draft supervisory statement is compatible with the Regulatory Principles as the PRA sets out transparent and proportionate expectations on firms in relation to the Solvency 2 Regulations.[2]

Cost benefit analysis

4.4 The proposal that firms with an approved internal model should report the standard formula SCR information on an annual basis will generate some additional costs. However, the PRA does not expect the additional costs to be significant. This is because firms with internal model approval are already required to maintain, at all times, the ability to calculate their standard formula SCR.

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1 Upon request by the PRA, a firm with an internal model approval must provide the PRA with an estimate of the SCR determined in accordance with the standard formula.

2 2015 No. 575 Financial Services and Markets, The Solvency 2 Regulations 2015

4.5 In addition, all firms that received approval to use an internal model in December 2015 provided the standard formula SCR calculations as part of their internal model application submissions, as well as the individual capital assessment (ICA) results for the last three years through ad-hoc PRA data requests.

4.6 The proposal will help the PRA to better monitor any model drift, to ensure that firms' capital requirements properly reflect the risk undertaken, and will therefore support the PRA's objectives of promoting the safety and soundness of firms and securing an appropriate degree of protection for policyholders.

Impact on competition

4.7 When making general policy, the PRA is required, in so far as is reasonably possible, to facilitate effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.

4.8 By helping to ensure firms maintain adequate capital levels, this proposal should facilitate effective competition by preventing firms from taking excessive risks, and/or under-assessing risks, both of which could create barriers to entry and expansion for new and existing competitors who assess risk prudently.

Impact on mutuals

4.9 In the PRA's opinion, the impact of the proposed rule changes on mutuals is expected to be no different to the impact on other firms.

Equality and diversity

4.10 The PRA is required by the Equalities Act 2010 to have due regard to the need to eliminate discrimination and to promote quality of opportunity in carrying out its policies, services and functions.

4.11 The PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications.

Appendices

1	**Draft supervisory statement 'Solvency II: Monitoring model drift and standard formula SCR reporting for firms with an approval internal model'**
2	**Template SF1, available at www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp2216.aspx**

Appendix 1 : Draft supervisory statement 'Solvency II: Monitoring model drift and standard formula SCR reporting for firms with an approval internal model'

Contents

1 Introduction

1.1 This supervisory statement sets out Prudential Regulation Authority's (PRA) expectations of firms with an approved internal model, and provides further information on the PRA's approach to monitoring model drift and the reporting of standard formula Solvency Capital Requirement (SCR) information.

1.2 This supervisory statement is relevant to UK solo insurance firms within the scope of Solvency II, including undertakings where the solo SCR is calculated by a group internal model, the Society of Lloyd's in respect of each of their Syndicates, and in respect of outputs of the Lloyd's internal model.

2 Monitoring model drift

2.1 The PRA has developed an approach to monitoring model drift - the risk that capital requirements calculated using an internal model may drift over time.

2.2 The PRA's approach includes the monitoring of the internal model SCR against certain objective measures of risk. The model drift ratios will be calculated at the point of model approval and re-based following a change in risk profile or major model change.

2.3 These objective measures of risk, for which different measures may be used over time, include standard formula SCR, pre-corridor Minimum Capital Requirement (MCR), net written premium and best estimate liabilities.

2.4 Monitoring model drift is one tool that the PRA uses to help ensure that capital requirements under Solvency II remain reflective of the risks that firms are exposed to, ensuring that the soundness of firms and protection for policyholders are not weakened over time.

2.5 This tool helps the PRA to monitor model drift at firm, sector and industry level.

3 Reporting the standard formula SCR

3.1 As set out above, the PRA considers that the standard formula SCR is a useful measure to monitor model drift.

3.2 Firms that received approval to use an internal model before 1 January 2016 provided the standard formula SCR calculations as part of their internal model application submissions, as well as the individual capital assessment (ICA) results leading up to implementation of Solvency II through ad-hoc PRA data requests. The PRA considers that firms with internal model approval may find it useful to continue to carry out such calculations as part of their risk management, ORSA and other narrative reporting and model validation cycle.

3.3 The Solvency Capital Requirement – Internal Models 3.4 part of the PRA Rulebook [1] requires a firm with an internal model approval to provide the PRA, upon request, with an estimate of the SCR determined in accordance with the standard formula.

1 Upon request by the PRA, a firm with an internal model approval must provide the PRA with an estimate of the SCR determined in accordance with the standard formula.

3.4 Further, the PRA can revoke model approval in certain circumstances and a firm would in that case be required to determine their SCR using the standard formula.

3.5 Therefore in order to be able to comply with a request by the PRA to provide an estimate of the SCR calculated using the standard formula, or to calculate its SCR in case of revocation of model approval, the PRA expects firms with internal model approval at all times to maintain the ability to calculate their SCR using the standard formula.

3.6 In addition, the PRA expects firms using an approved internal model to calculate their solo SCR to report the results of their standard formula SCR calculation using the template provided in the appendix. The PRA considers that these templates will make it easier and simpler for firms to supply the relevant information.

3.7 The template should be submitted at the same time firms submit their annual quantitative reporting templates in accordance with the rules for deadlines set out in the Reporting Part of the PRA Rulebook. Firms that received internal model approval before 1 January 2016 should also submit a template as at the date of their opening Solvency II financial statements.

3.8 For groups that use an approved group internal model where the PRA is the group supervisor, the PRA may request standard formula SCR information at group level. Firms will be notified of group level requests via their supervisor.

3.9 Firms may wish to submit supporting quantitative and qualitative documentation with their template submission. For example, a firm may provide additional information as to the appropriateness of the standard formula SCR calculation for the purpose of monitoring model drift.

3.10 Completed templates should be submitted through the Bank of England Electronic Data Submission (BEEDS) portal as ‘occasional submissions’.

Appendix

1 Template SF1, available at www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp2216.aspx