Association of British Insurers

ABI response
CP22/16 Solvency II: Monitoring model drift and standard formula SCR reporting for firms with an approved internal model

The UK Insurance Industry

The UK insurance industry is the largest in Europe and the third largest in the world. It plays an essential part in the UK's economic strength, managing investments of £1.8 trillion (equivalent to 25% of the UK's total net worth) and paying nearly £12bn annually in taxes to the Government. It employs around 315,000 individuals, of whom more than a third are employed directly by insurers with the remainder in auxiliary services such as broking.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed.

The ABI

The Association of British Insurers is the leading trade association for insurers and providers of long term savings. Our 250 members include most household names and specialist providers who contribute £12bn in taxes and manage investments of £1.8trillion.
The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and advocating on behalf of insurers
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance
- Promote the benefits of insurance to government, regulators, policy makers and the public

We welcome the opportunity to comment on the PRA's consultation CP22/16 Solvency II: Monitoring model drift and standard formula SCR reporting for firms with an approved internal model

ABI Key messages

- While we understand the PRA's objective of ensuring internal models remain appropriate over time, there are simpler and more effective ways of achieving this.
- In particular, firms already report to the PRA about major and minor changes, and these could serve as the basis for monitoring changes.
- Insurers use internal models because they reflect their business models more accurately. Given that the standard formula would not capture an internal model's risk profile well, it would also not serve as an appropriate point of comparison.
- We are concerned about the immediate impact of the proposal, should it be implemented. The reporting of SCR results goes beyond the Solvency II Directive, and UK insurers will be placed at a competitive disadvantage compared to continental firms. UK firms would face greater compliance costs and increased burden on management time, as both internal model and standard formula results would now need to be produced and explained.
- We are equally concerned about the longer-term impact of the proposal, including the potential for an insurer having to manage its business to two measures, and the pressure to publically disclose the results – with the risk that these are misinterpreted.

Detailed comments

There are other alternatives to assessing the suitability of changes to internal models

- The PRA's objective of monitoring capital levels and model appropriateness is understandable. However, the information the PRA proposes to collect to monitor model drift is already provided to the PRA by other means, which could achieve the PRA's objectives:
  - Any major changes or combination of minor changes are already subject to PRA scrutiny. Firms provide the PRA with analyses of these changes which cover the financial impact of each model change, including material calibration changes;
  - An internal change log is already used to track the impact of model change over time, and firms are required to report minor model changes to the PRA each quarter;
  - These two alternatives could be used by the PRA as a more immediately available and cost effective way of monitoring changes in internal models.
- There appears to be some distrust of insurers' use of models based on experience with the banking sector. However, the regulatory frameworks are not the same, and supervisors have a series of means to monitor insurers' models. Indeed, we are not aware of any evidence that when the ICAS regime was introduced in the UK there was then any material downward drift in capital.

Consistency with Solvency II: firms should be required to provide estimates of the SCR, in line with the requirements of Solvency II

- Article 112(7) of the Solvency II Directive states that:
  "After having received approval from supervisory authorities to use an internal model, insurance and reinsurance undertakings may, by means of a decision stating the reasons, be required to provide supervisory authorities with an estimate of the Solvency Capital Requirement determined in accordance with the standard formula, as set out in Subsection 2."
- The article thus requires an **estimate** of the SCR rather than a full calculation. However, the CP wording in Appendix 1 Section 3.5 is for firms to *"…to calculate their SCR using the standard formula*". This is a strengthening of the requirements, as it has removed the word "estimate".
- We propose that the PRA alters the wording to *"…estimate their SCR determined in accordance with the standard formula*" to ensure consistency with the Solvency II Directive.
- Supplying an estimate would also mean that firms will be less exposed to the demands of third parties to disclose their standard formula results.

Implementing the proposals would place UK firms at a competitive disadvantage

- Unless the requirement is clarified to allow for the provision of SCR estimates, the proposals go beyond the Solvency II Directive. This would place UK firms at a competitive disadvantage:
  - Firms have set themselves up to be able to estimate their standard formula results, and only if asked (per the Directive);
  - Producing a completely accurate SCR will be labour intensive for firms which are not set up to productionise these numbers on an annual basis, with the extra layer of governance, analysis and sign-off that would then go with this;
  - In relation to paragraph 3.4, although the PRA might be able to revoke internal model approval, in practice, this should only occur at the end of a discussion on why the internal model is no longer appropriate and consideration of whether the standard formula is suitable for the risk profile

of the firm (which is generally unlikely to be the case). There should therefore be time for a firm to prepare itself for moving to using its full standard formula reporting capability.
    - As mentioned above, there is also a risk that insurers would have to manage their business to more than one metric or that the measure would evolve to become an early warning indicator.
- The above would amount to additional burdens on UK firms that are not being made on other firms, placing UK insurers at a relative disadvantage.

If the standard formula is not an appropriate measure of risk for some firms, it is also not an appropriate comparator

- Firms are using internal models because it is the most appropriate way to calculate risk and manage their business. Indeed, internal models are an integral part of the Solvency II regime, and it is unlikely that the PRA would permit these firms to use the standard formula as it would not appropriately reflect their business:
    - The application process would have demonstrated that the internal model is a better fit to the firm's risk profile than the standard formula and so any deviations in ratios between the two SCR numbers are likely to be more about the differences in the calculation than changes in the adequacy of the internal model itself;
    - We are concerned that standard formula SCR reporting would detract from internal model results, even though this is the right basis to run the business;
    - The annual requirement to calculate a standard formula SCR acts to increase the costs of insurers. By introducing this requirement, firms will need to consider how the standard formula changes as much as how the internal model changes;
    - We also note that it is not clear which standard formula calculation the PRA is referring to, and whether this includes transitional measures.
- We further note the following specific examples:
    - There are structural differences between the standard formula and insurers' internal models. For example, insurers' treatment of ring-fenced funds, matching adjustment and pension schemes via internal models can differ from the standard formula and it would therefore be misleading to compare these;
    - The standard formula misses certain risks that will be captured within the internal model (e.g., volatility risks, longevity trend) or adopts an approach for other risks which is not risk-sensitive (e.g., operational risk);
    - Whilst undiversified exposures may differ, this will be magnified by the diversification, further distorting the comparability;
    - Best Estimate Liabilities could also pose some difficulties for monitoring. For example, the non-unit component of the best estimate for unit linked business might be a better measure for assessing relative risk than the full best estimate. The best estimate for with-profits business may also raise movements in relativity through its non-linear behaviour;
    - Geographic diversification of a general insurer's risks is poorly captured in the standard formula.

We are concerned firms would need to manage their business to two measures

- The introduction of standard formula SCR reporting may result in firms needing to manage their business to two measures, particularly if there is pressure from analysts to disclose results.

- Explaining internally and externally the movements in the ratios is resource intensive, and would hinder effective risk management and business decision-making.
- In the medium term, there could be potential challenge from Boards as to why firms have invested so significantly in developing and using internal models, when the focus is now on managing, explaining and disclosing standard formula results;
- There is also a risk of the purpose and implications of the ratios being misinterpreted, and we are concerned that this may over time turn into an early warning indicator.
- This, alongside concerns about the costs and appropriateness of comparison, could combine to incentivise insurers not to adopt internal models, reducing the insight that insurers and supervisors have of capital and risks.

Reporting the standard formula SCR

- If model drift is more likely to occur over a period of time, spanning multiple years, it is not clear what the usefulness is of providing the information on an annual basis.
- If the requirement for annual reporting is maintained, we are unsure why the PRA requires the information to be submitted at the same time as the annual quantitative reporting templates. We would suggest that a later deadline for submission would give firms greater flexibility to choose whether to produce the standard formula results along with their internal model reporting (if they wished to and were able to) or to delay calculation/governance of the standard formula results until their primary internal models results have been finalised.
- We are unsure why the PRA cannot clarify in this Statement as to whether it will require results at group level. If the position is to be left open, it would be useful for the PRA to comment on whether such requests might be annual or just ad-hoc.

Comments on the appendix

- SF1 template, Row 15 in the proposed template requires a capital add-on. However, where an Internal Model firm has a capital add-on this will relate to the internal model SCR and therefore would not necessarily apply to the standard formula SCR. It would be more appropriate to remove this cell from the template and for the PRA to perform comparisons of the Internal Model SCR and Standard Formula SCRs prior to any capital add-ons.