Association of British Insurers

ABI response
CP19/16 Solvency II: Changes to internal models used by UK insurance firms

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 CP19/16 Solvency II: Changes to internal models used by UK insurance firms.

Key messages

- Solvency II is now live as part of 'business as usual' for firms and the PRA. Last year the PRA approved 19 firms to use internal models to calculate their regulatory capital requirements and manage their businesses; other UK firms have had internal models approved since and by National Competent Authorities in different Member States. These firms are planning changes to their models for a variety of reasons – including in response to PRA feedback – as their business models evolve and the risks insurers are exposed to change.

The PRA should seek to review and approve model change applications within three months

- The prospect of a six month wait for approval of a major change will lead to a range of practical challenges, including the release of numbers to the markets, satisfying use test requirements and the impact on business decision-making by introducing avoidable uncertainty.
- Assurances of a quicker approval period will enable firms to manage their business more efficiently and hold regulatory capital that is appropriate to the current nature, scale and complexity of their business and risk exposure.

There is some duplication with previously published requirements and guidance and firms' approved model change policies – these should be the starting point

- The Solvency II Directive, the associated legal text, and the EIOPA Guidelines on the use of internal models contain a range of requirements and guidance on internal model changes. We suggest these details are not repeated in the final supervisory statement to limit duplication and the risk of inconsistency.
- As part of their initial internal model application, firms have developed an internal model change policy, based on the existing requirements, which have received approval from the PRA. This policy should be the starting point for firms' internal model change process, how minor and major changes are defined, and the interactions between them.

Minor model changes should be timely reviewed by PRA as part of ongoing supervision, avoiding the risk and complication of later unwinding them

- We have strong concerns regarding the implications for firms of needing to unwind minor model changes, should either a subsequent single major model change or accumulation of minor changes not be approved. This requirement would go beyond the EIOPA Guidelines.
- Per EIOPA Guidelines, firms already report to the PRA at least quarterly all minor model changes. There is an onus on the PRA to review and, if appropriate, challenge these changes as part of its ongoing supervisory review, and do to so in a timely way.
- Any concerns regarding minor model changes should thus be raised by the PRA based on these quarterly submissions and not when a model change application is submitted.

Model change documentation should focus on the changes and be proportionate; a full internal model re-application would be unduly onerous

- The ongoing model change process should be managed in a way that focuses on materiality and proportionality, in order to be manageable for both firms and the PRA.
- In particular, we suggest that instead of being required to resubmit a full internal model application, the documentation required to be updated and submitted should be proportionate to the change(s), whilst being sufficient to explain the nature of the changes(s), its impact and how it has been validated, reviewed and approved.

Detailed comments

Section	Reference	Comments
1. Overview		*[none]*
2. Proposals		*[none]*
3. The PRA's statutory obligations	3.4	• The PRA states that its expectations in relationship to the quality and content of a model change application "do no impose additional requirements" on firms. • However limiting firms to one major model change application per year is a restriction which goes beyond the Solvency II Directive, associated legal text and EIOPA Guidelines. Furthermore, this is inconsistent with the approach being taken by many other National Competent Authorities. • The PRA should develop guidance and expectations within the European context and ensure it does not create additional restrictions for UK firms (versa firms operating in other Member States) which hinders the 'level playing field' concept of Solvency II.
	3.9	• The PRA notes that there are no specific fees for model change applications and that this policy will be kept under review. • Internal models are a core part of the Solvency II prudential regime. For many firms the standard formula is not appropriate, making the internal model approach effectively mandatory. Firms already pay PRA periodic fees to cover the PRA's supervisory 'business as usual'. Internal model applications and approvals are a part of this business as usual activity, the cost of which should be covered by the PRA regulated fees firms currently pay. This covers all PRA activity other than special project fees (those for Solvency II have ceased) and authorisation fees (which are entirely one-off). • The ABI would wish to engage in any future consultation to amend this approach.

Section	Reference	Comments
	3.10	• The PRA states that the limitation of one major model change per year is an "expectation rather than a requirement". This clarification is an important one. • The PRA states that firms are not precluded from making more than one application in a year "should business or market conditions require it". We suggest this is also reflected in the final version of the supervisory statement; the draft supervisory statement (para 2.5) only refers to the "new or unforeseen business transactions" as an example reason for more than one model change application. • There are many triggers that may require an internal model to be changed; the timing of these triggers is not always predictable and hence it is feasible that more than one change may be required in a year. • It would be helpful for the PRA to provide a (non-exhaustive) list of examples of these triggers, including: updates to external modelling tools (e.g. cat risk models); changes in the external economic environment and material changes in risk profile.
Appendix: Draft supervisory statement – Solvency II: Changes to internal models used by UK insurance firms *Section 1. Introduction*	General comments	**The draft supervisory statement duplicates many of the requirements and guidance already published** • The Solvency II Directive, the associated legal text, and the EIOPA Guidelines on the use of internal models contain a range of requirements and guidance on internal model changes. We suggest that these details are not repeated in the final supervisory statement to limit duplication and the risk of inconsistency or ambiguity. **Firms' internal model change policies, approved by the PRA, should be the starting point for making model changes** • As part of their initial internal model application, firms have developed an internal model change policy, in line with the legal text, EIOPA Guidelines and other PRA guidance, which has received approval from the PRA. This policy should be the starting point for firms' internal model change process including how minor and major changes are defined, and the interactions between them.

Section	Reference	Comments
		A consistent approach is needed across the PRA's supervisory teams • Feedback from ABI members indicates there has been an inconsistent feedback given to different firms from PRA supervisory teams on their model change policy, its structure, contents and application of it. • Feedback from the PRA to firms on this issue – as with any other – should be given to firms in a form that is consistent regardless of the supervisory team.
	1.6	• The PRA states that the same supervisory approval process should be adopted 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. It is important that this process is proportionate to the size, scale and complexity of the proposed changes. **Changes to the model change policy** • The PRA proposes a standalone review process for applications to make changes to the policy for changing the internal model. • Paragraph 2.14 of the draft supervisory statement indicates that firms can align this application with a model change application and paragraph 4.5 outlines the information require as part of this application. However, the draft supervisory statement is silent on what this standalone review process will be. This should be outlined in the final supervisory statement.
Appendix: Draft supervisory statement – Solvency II: Changes to internal models used by UK insurance firms *Section 2. Interaction with the PRA before and during a model change application*	2.3	• The draft supervisory statement states that the PRA expects model change applications to address "past PRA feedback, past data audits, limitations of the model, improvements driven by ongoing use…, validation findings and findings arising from the PRA's supervisory review process". • This could be interpreted as meaning that *all* such prior feedback should be addressed by an application; however the final sentence proposes that firms must articulate their rationale for identifying and prioritising model changes(s). • This implies it is appropriate for firms to prioritise the most material feedback and not address all feedback in the next model change application. We agree with this and suggest it is made clearer and less ambiguous.

Section	Reference	Comments
	2.5	• In the consultation paper pre-ample, para 3.10 states that the limitation of one major model change per year is an "expectation rather than a requirement". It states that firms are not precluded from making more than one application in a year "should business or market conditions require it". • We suggest this is also reflected in the final version of the supervisory statement; as the draft supervisory statement only refers to the "new or unforeseen business transactions" as an example reason for more than one model change application per year. • There are many triggers that may require an internal model to be changed; the timing of these triggers is not always predictable and hence it is feasible that more than one change may be required in a year. • It would be helpful for the PRA to provide a (non-exhaustive) list of examples of these triggers, including: updates to external modelling tools (e.g. cat risk models); changes in the external economic environment and material changes in risk profile. • It is proposed that a model change application may comprise "several individual major changes… which will be reviewed together". This is pragmatic however there is a potential unintended consequence: If the PRA has a concern with one aspect then this could lead to the rejection of the whole application, even if the other changes would be approved under a standalone application.
	2.8	• The final sentence should be amended in the final supervisory statement to state that the PRA has "from the date of a complete application *being received* to provide a decision". This is in line with Article 3(4) of the Implementation Technical Regulation, and avoids any ambiguity as to when the application period begins. • Following submission of a formal and complete model change application, a firm can then wait up to six months for a decision from the PRA. Whilst acknowledging that this is in line with the Solvency II Directive and Delegated Regulations, we note this is a significant period of time, during which the business and external factors will continue to evolve. • The prospect of a six month wait for approval of a major change will lead to a range of practical challenges, including with the release of numbers to the markets, satisfying use test requirements and will impact business decision-making by introducing avoidable uncertainty. • Assurances of a quicker approval period will enable firms to manage their business and hold regulatory capital that is appropriate to the current nature, scale and complexity of their business and risk exposure.

Section	Reference	Comments
		• This should be feasible particularly where there has been significant interaction with the PRA before formal submission of an application (per para 2.1 to 2.7), and potentially even a pre-application review process (per para 2.4). • The approval process, timelines and extent of supervisory review should be symmetrical in respect of model changes whether they lead to increase or decrease capital requirements.

	2.9	• We note that in line with the EIOPA Guidelines, firms are already reporting to the PRA at least quarterly all minor model changes – regardless of whether or not a major model change application is planned or pending.
		• The draft supervisory statement states the PRA will "consider whether the minor change accumulations are reset at that point", which we interpret to mean upon receiving an application for a major model change.
		• As the model change process involves reviewing and approving all changes to a model previously approved, approval from the PRA should always include the reset of accumulated minor changes. The final supervisory statement should make this point more clearly.
		• Further, whilst a model change application is pending, it is important that firms can continue to make ongoing minor changes to their model – with the associated reporting requirements – to ensure the model continues to evolve with the business and external environment.
		  ○ The draft supervisory statement states that "Subsequent to the application of a model change the PRA expects firms to contact their supervisor when making minor changes to their model".
		  ○ We propose that this sentence be deleted – as it would result in firms following a different process for minor changes during the application phase. Without deleting, and if it were to take six months to receive model change approval, this would mean that for half of most and quite possible all years, firms would be required to apply a different minor changes process – an additional process resulting in unnecessary complexity and not required by EIOPA Guidelines.
		• In addition to the model change approval triggering the reset of accumulated minor changes, we suggest that there should also be the option for a reset to happen over time with the agreement of the PRA but without the need for a model change application. This process should be specified in the model change policy agreed with the PRA.

Section	Reference	Comments
	2.13	• We have strong concerns regarding the implications for firms of needing to unwind minor model changes, should either a subsequent single major model change or accumulation of minor changes not be approved. This requirement would go beyond the EIOPA Guidelines. • Per EIOPA Guidelines, firms already report to the PRA at least quarterly all minor model changes. There is an onus on the PRA to proactively review quarterly model change reports and, if appropriate, challenge these changes as part of its ongoing supervisory review. This should be done in a timely way – we propose within the next quarter, rather than "at any time" as proposed in 2.10. Firms operate with robust and effective governance structures – themselves reviewed by the PRA – which can provide appropriate review of minor model changes, rather than the PRA effectively having the indefinite ability to reject these changes. • Any concerns regarding minor model changes should thus be raised by the PRA based on these quarterly submissions and not at the future point when a model change application is submitted.
Appendix: Draft supervisory statement – Solvency II: Changes to internal models used by UK insurance firms *Section 3. The quality of model change applications*		*[none]*
Appendix: Draft supervisory statement – Solvency II: Changes to internal models used by UK insurance firms *Section 4. The information to be provided with a model change application*	General comments	• The application process as set out in the draft supervisory statement will be very onerous on both firms and the PRA. It is important to strike a balance so as not to disincentivise model changes when these would be supportive of more effective prudential risk management. • For many firms the IMAP process was undertaken by a project team working with the business. Going forward, this should not be necessary for the model change process, in order to avoid disproportionate ongoing costs.
	4.3	• The ongoing model change process should be managed in a way that focuses on materiality and proportionality, in order to be manageable for both firms and the PRA. • 4.3(b) proposes that a model change application need only include documents where their content would be affected by the major change. Similarly, we propose that the same concept should apply to the documentary evidence referred to in 4.3(d).

Section	Reference	Comments
	4.4	• Instead of being required to resubmit a full internal model application for each model change, the documentation required to be updated and submitted should be proportionate to the change whilst being sufficient to explain the nature of the changes(s), its impact and how it has been validated, reviewed and approved.