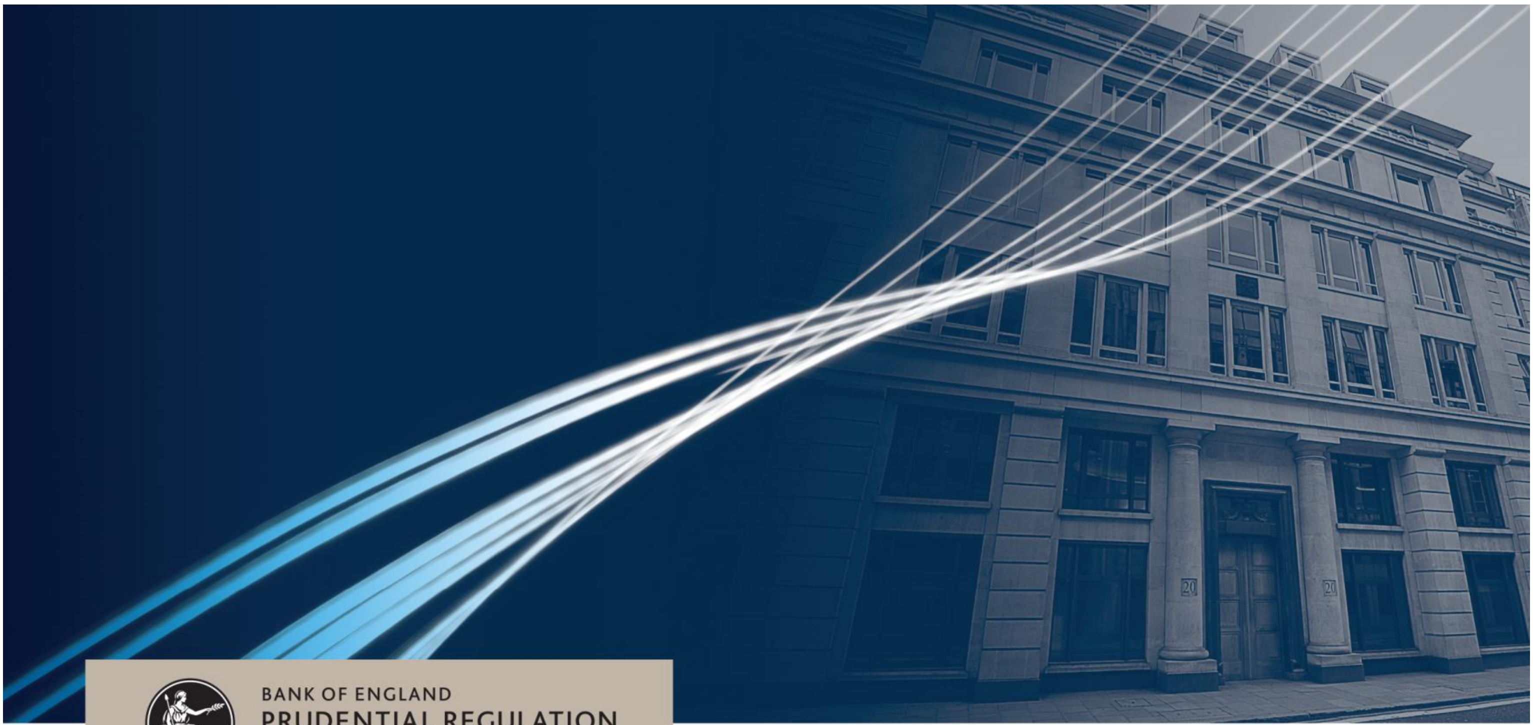

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP27/17

Solvency II: Internal models update

December 2017

Prudential Regulation Authority
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Responses are requested by Tuesday 20 March 2018.

Please address any comments or enquiries to:
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Rachel Evans, for reporting change

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Contents

1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) proposes updated expectations of firms in respect of the model change process set out in Supervisory Statement (SS) 12/16 'Solvency II: Changes to internal models used by UK insurance firms'[1] and internal model change policies set out in SS17/16 'Solvency II: internal models – assessment, model change and the role of non-executive directors'.[2] This CP also proposes a process for quarterly model change reporting.

1.2 The proposals in this CP have been developed by the PRA as part of its work on adjustments to the insurance prudential framework in the light of experience following the introduction of Solvency II in the United Kingdom. This includes a series of improvements that support the PRA's commitment to the Treasury Select Committee.[3] The proposals are aimed at reducing the burden on firms and making better use of supervisory resources in pursuit of the PRA's objectives.

1.3 This CP is relevant to all UK Solvency II firms, the Society of Lloyd's and its managing agents. It is most relevant to firms that have an internal model approval. It may also be of interest to UK Solvency II firms seeking approval to use an internal model and to UK Solvency II firms that are part of the European Economic Area (EEA) or non-EEA groups with a group internal model.

Background

1.4 Guidance on internal model change policies was issued in a Director's letter in May 2015. This was later consulted on as part of the consolidation of Director's letters[4] and issued as SS17/16 in November 2016.[5] Guidance on the model change process was consulted on in May 2016[6] and issued as SS12/16 in September 2016.[7]

1.5 The PRA has reviewed the effectiveness of certain aspects of the model change process. This review, together with the recent discussions with the ABI and industry participants, has resulted in the proposed updates to the PRA's guidance on the model change process, model change policies and the reporting of minor model changes.

1.6 Alongside the publication of this CP, the PRA has also published a statement setting out its review of the time it had taken to assess model change applications approved since the implementation of Solvency II on 1 January 2016; how firms had completed the Common

1 September 2016: www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-changes-to-internal-models-used-by-uk-insurance-firms-ss.
2 November 2016: www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-internal-models-assessment-model-change-and-the-role-of-non-executive-directors-ss.
3 News Release 'PRA launches a series of improvements to the implementation of Solvency II', 25 October 2017: www.bankofengland.co.uk/news/2017/october/pra-launches-series-of-improvements-to-the-implementation-of-solvency-ii.
4 CP20/16 'Solvency II: consolidation of Directors' letters', May 2016: www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency-2-consolidation-of-directors-letters.
5 'Solvency II: internal models – assessment, model change and the role of non-executive directors': www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-internal-models-assessment-model-change-and-the-role-of-non-executive-directors-ss.
6 CP19/16 'Solvency II: Changes to internal models used by UK insurance firms': www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency-2-changes-to-internal-models-used-by-uk-insurance-firms.
7 'Solvency II: Changes to internal models used by UK insurance firms': www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-changes-to-internal-models-used-by-uk-insurance-firms-ss.

Application Package (CAP) when making model change applications; and how firms have defined model changes in model change policies.[1]

Implementation

1.7 The PRA proposes that the updated guidance on the model change process and model change policies would be implemented in 2018 Q2. The PRA considers that the proposed change to the model change process would result in the need for firms to modify their model change policies. Changes to the model change policy are subject to supervisory approval following the procedure set out in paragraph 2.14 of SS12/16.

1.8 The PRA proposes that the changes in relation to minor model change reporting would take effect from June 2018.

Responses and next steps

1.9 This consultation closes on Tuesday 20 March 2018. The PRA invites feedback on the proposals in this consultation set out by chapter. Please address any comments or enquiries to CP27_17@bankofengland.co.uk.

1 'Solvency II: PRA review of model change related processes, policies and reporting', December 2017: www.bankofengland.co.uk/prudential-regulation/publication/2017/pra-statement-solvency-ii-pra-review-of-model-change-related-processes-policies-and-reporting.

2 Proposals

2.1 This chapter sets out the PRA's proposals in respect of:

- an annual reset of minor model change accumulations (Appendix 1 – update to SS12/16);
- firms' model change policies (Appendix 2 - update to SS17/16); and
- minor model change reporting (Appendix 2 – update to SS17/16).

Model change accumulations

2.2 SS12/16 sets out the process of resetting minor model change accumulations when a major model change is applied for. Separate to the model change process, the PRA now proposes an additional annual reset of minor model change accumulations for minor model change accumulations. The annual reset applies to minor model changes which do not trigger the major change threshold within an annual cycle (that firms may specify) and that are not linked to a major model change. If the major change threshold for minor model change accumulations is not breached in any given annual cycle, those accumulated minor changes would not be, of themselves, a major change that requires firms to submit a major model change application.

2.3 Given that minor model changes are reported regularly to the PRA and firms are required to meet test and standards at all times, the PRA considers there to be limited benefit in a regular approval process for accumulated minor model changes. The PRA therefore considers that the reset of minor model change at the end of an annual cycle as described in paragraph 2.14 would reduce the frequency with which an accumulation of minor changes would trigger the need for firms to submit a model change application. This will reduce the burden on firms and make better use of the PRA's supervisory resources in pursuit of the PRA's objectives.

2.4 Firms are encouraged to discuss the accumulated minor changes with the PRA prior to resetting accumulations with the aim of ensuring a common understanding of the minor changes and their interaction with the model as a whole.

2.5 The PRA considers that in order to implement an annual reset of minor model change accumulations, firms will need to modify their model change policies.

Model change policies

2.6 The PRA proposes to clarify its expectation regarding the scope of firms' model change policies in an update to SS17/16 (Appendix 2). The draft SS sets out that model change policies should contain clear definitions of model changes which cover a sufficiently broad range of potential sources of changes, in line with EIOPA's Guideline 6 on the use of internal models.[1]

1 http://eiopa.europa.eu/Publications/Guidelines/IM_Final_document_EN.pdf.

2.7 Firms may wish to review their major model change thresholds at the same time as, and to take account of, any change to the minor model change accumulation reset point that the firm might ultimately make pursuant to the proposal described in paragraphs 2.14 and 2.15 of this CP. Proposed changes to model change policies need to be approved by the PRA before being implemented by firms.

2.8 The PRA considers that these proposals would improve the effectiveness of identifying and reporting all relevant sources of change that would impact the Solvency Capital Requirement (SCR). They are also expected to improve the consistency in the types of model changes which are identified and reported.

Minor model change reporting

Submission of quarterly minor model change reports via the Bank of England Electronic Data Submission (BEEDS) portal

2.9 The PRA proposes that firms with an approved internal model submit model change reports via BEEDS. Reports are sent quarterly or more frequently if required.

2.10 This would align the process with other Solvency II quantitative and qualitative reporting submissions and would ensure simpler, more secure tracking and recording procedures by firms and the PRA.

Submission of quarterly minor model change reports within five weeks of a quarter end

2.11 The PRA proposes that firms with an approved internal model submit their quarterly minor model change reports within five weeks of the reference quarter end.

2.12 This would align the submission with the quantitative quarterly reporting submission periods that will apply after the rules in Transitional Measures 3.3 of the PRA Rulebook cease to have effect (i.e. from 1 January 2020). This would also help to support timely supervisory analysis of changes made for both individual firms and across peers or sectors.

Submission of quarterly minor model change information using a standardised template

2.13 The PRA encourages firms with an approved internal model to submit their quarterly minor model change information using a standardised template provided by the PRA.

2.14 While the submission of the template would be optional the PRA would encourage the submission of key information regarding model changes as a minimum. A standardised format would allow for quicker analysis and feedback if necessary.

3 The PRA's statutory obligations

3.1 In carrying out its policy making functions, the PRA is required to comply with several legal obligations.

3.2 The PRA is required by the Financial Services and Markets Act 2000 (FSMA)[1] to consult when setting its general policies and practices.[2] In doing so, it is required to comply with several statutory and public law obligations. The PRA meets these obligations by providing the following in its consultations:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective,[3] insurance objective,[4] and secondary competition objective;[5]
- an explanation of the PRA's reasons for believing that making the proposed policy are compatible with its duty to have regard to the regulatory principles;[6] and
- a statement as to whether the impact of the proposed policy will be significantly different to mutuals than to other persons.[7]

3.3 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[8]

3.4 The PRA is also required by the Equality Act 2010[9] to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.5 The proposals in relation to minor model change accumulations introduce a slight increase in prudential risk as it will reduce the frequency with which firms have to seek PRA approval for changes to their internal models, and therefore increase the potential for 'model drift'. However the PRA considers this is mitigated by firms monitoring model drift as set out in SS15/16 'Solvency II: Monitoring model drift and standard formula SCR reporting for firms with an approved internal model',[10] and the proposals for the PRA to receive more timely minor model change reporting. Further, these proposals will benefit firms and the PRA as the likelihood of a major model change due to the accumulation of minor changes will be reduced, with a consequent potential reduction in the level of resource required to enact these changes.

1 Section 138J of FSMA.
2 Section 2L of FSMA
3 Section 2B of FSMA.
4 Section 2C of FSMA.
5 Section 2H(1) of FSMA.
6 Section 2H(2) and 3B of FSMA.
7 Section 138K of FSMA.
8 Section 30B of the Bank of England Act 1998.
9 Section 149.
10 October 2016: www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-monitoring-model-drift-and-standard-formula-scr-reporting-ss.

3.6 The proposals clarify the PRA's expectations of model change policies and do not impose additional requirements.

3.7 The reporting proposals contained in the update to SS17/16 clarify the PRA's expectations of firms and provide firms with an optional template to use when submitting the relevant information. The PRA does not expect this to introduce material additional costs to firms.

3.8 The submission of reports via BEEDS does not increase costs for firms. Solvency II firms are required to submit a number of reports via BEEDS, both using XBRL format and submitting other documents as 'occasional submissions'.

3.9 A number of firms already submit their quarterly minor model reports within five weeks of a reference quarter end. The cost to firms that currently submit reports after five weeks is minimal given the type of information requested.

3.10 Submitting the requested information via a standardised template may slightly increase costs to firms in terms of the effort required but this is not expected to be material. The information requested is the minimum information that the PRA would expect firms to be monitoring internally as part of their responsibility to adhere to their model change policies and should therefore be available to submit to the PRA.

Compatibility with the PRA's objectives

3.11 The PRA considers that the proposals in this CP are compatible with the PRA's statutory objectives to promote the safety and soundness of PRA-authorised firms and, in the context of insurance, to contribute to policyholder protection. The PRA is seeking to ensure the delivery of the main objective of the Solvency II Directive as described in Article 27 (ie the protection of policyholders and beneficiaries) by providing guidance to firms.

3.12 The PRA also has a duty to facilitate effective competition as a secondary objective subordinate to its general safety and soundness objective. The PRA expects the proposals in this CP would not have an adverse effect on effective competition. The effect on competition of the implementation of the Solvency II Directive has already been considered in the FSA's CP11/22 'Transposition of Solvency II'[1] and the PRA's CP16/14 'Transposition of Solvency II: Part 3'.[2]

Regulatory principles

3.13 In developing the proposals in this CP, the PRA has had regard to the regulatory principles as set out in FSMA. Two of the principles are of particular relevance:

(i) the principle that a burden or restriction which is imposed on a firm should be proportionate to the benefits which are expected to result from the imposition of that burden. The PRA has followed this principle when developing the proposals outlined in this CP, and has indicated in the CP the key areas of its judgements. The PRA's approach of articulating the outcomes to be achieved in relation to the annual reset of

1 November 2011: www.fsa.gov.uk/pubs/cp/cp11_22.pdf.
2 August 2014: www.bankofengland.co.uk/prudential-regulation/publication/2014/transposition-of-solvency-2-part-3.

minor model change accumulations and model change reporting is consistent with taking a proportionate approach; and

(ii) the principle that the PRA should exercise its functions as transparently as possible. The PRA has followed this principle in providing updated guidance to enable firms to better realise the benefits of the internal model regime.

Impact on mutuals

3.14 In the PRA's opinion, the impact of the changes proposed in this CP on mutuals is expected to be no different from the impact on other firms.

HM Treasury recommendation letter

3.15 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.[1]

3.16 The PRA considers that two of these aspects are of particular relevance to these proposals:

(i) the PRA believes that the proposals setting out its expectations on the model change process and minor model change reporting will help to ensure the robustness of internal model processes and governance in these insurers and therefore the resilience of the financial system in the United Kingdom, which could help to sustain the reputation of London as a leading international financial centre; and

(ii) the PRA considers that the proposals are consistent with delivering better outcomes for consumers, through ensuring that insurers are aware of the PRA's expectations for internal model changes. The proposals set out expectations which will enable the PRA to take actions to address any weaknesses identified in insurers' model change process and governance.

Equality and diversity

3.17 The PRA does not consider that the proposals give rise to equality and diversity implications.

1 Information about the PRC and the recommendations from HM Treasury are available at www.bankofengland.co.uk/about/people/prudential-regulation-committee.

Appendices

Appendix 1: Draft update to Supervisory Statement 12/16 'Solvency II: Changes to internal models used by UK insurance firms'

Underlining indicates new text and striking through indicates deleted text.

…

2 Interaction with the PRA before and during a model change application

…

Interaction with the PRA during a model change application

…

2.11 While the PRA does not formally approve minor model changes, it will regularly review firms' reporting of minor changes[1] and may challenge any that it considers should be classified as a major model change. In addition, minor changes may be subject to review by the PRA at any time as part of the PRA's ongoing supervisory review process. If a minor change causes the model to no longer meet the Solvency II tests and standards, firms must address this issue.[2] Minor change accumulations will be reset at the end of an annual cycle (that firms may specify) and/or at the point of receiving a major change application (if that application is approved), unless otherwise agreed with the PRA.

2.11A Firms are encouraged to discuss accumulated minor changes with the PRA prior to resetting accumulations to zero in order to ensure a common understanding of the interaction between the various minor changes and the model as a whole.

.…

1 As per Guideline 8 of EIOPA's Guidelines on the use of internal models.
2 Solvency Capital Requirement – Internal Models, rule 9.1.

Appendix 2: Draft update to Supervisory Statement 17/16 'Solvency II: internal models – assessment, model change and the role of non-executive directors'

Underlining indicates new text and striking through indicates deleted text.

…

9 Internal model change policy

…

Scope of the model change policy

9.4 When defining the scope of the policy, firms are reminded to consider Guideline 6 (scope of the policy for model changes) of the EIOPA Guidelines on the use of internal models. It is important for firms to consider whether ~~it is~~ the scope of the model change policy and model change definitions are sufficiently broad and appropriately flexible to be able to capture any changes which could have a material impact on the SCR or to enable the firm to meet the T&S. For example, the policy recognises that a particular change to a technical provision model may be within scope if that change leads to an impact on the internal model SCR.

…

Combination of minor model changes

…

9.14 A reasonable starting point for each of these may be to:

- accumulate the absolute values of the impact of the minor changes together, unless it could be demonstrated why it would be reasonable to allow the impact of two minor changes to offset each other;

- accumulate changes from the date of the latest minor model change accumulation reset. Either at the end of an annual cycle (that firms may specify) and / or at the point of receiving a major change application (if that application is approved) ~~approved internal model(as per the EIOPA Guidelines on the use of internal models).[1] As part of this, it is sensible for firms to treat the resetting of the starting point of the accumulation (of minor changes) as a major change, unless otherwise agreed with the PRA as part of the supervisory review process. Resetting the accumulation period may arise as a result of qualitative considerations, for example to ensure alignment with the governance of the model or with the model development and validation cycles~~; and

- use indicators similar to those defined for single major changes, where considered appropriate.

…

1 EIOPA-BoS-14/180 EN.

…

Reporting of model changes to the PRA

9.19 In addition to submitting major changes for approval, according to the EIOPA Guidelines on the use of internal models, firms are expected to provide a quarterly summary of minor model changes to the PRA. It may be helpful for the summary to group related changes together, for example by risk area or function of the model.

Method of submission

9.19A The PRA expects firms with an approved internal model to submit their quarterly minor model change reports via the Bank of England Electronic Data Submission (BEEDs) portal.

9.19B Documentation should be submitted as 'occasional submissions'.

Timing

9.19C The PRA expects firms with an approved internal model to submit their quarterly minor model change reports within five weeks of the reference quarter end or more frequently where appropriate.

9.19D The PRA has provided a standardised template, for which firms can complete and submit, containing key information regarding minor model changes.

Format

9.19E While the submission of the relevant information via the template is optional; the PRA encourages firms to submit information consistent with that outlined in the template as a minimum within their quarterly minor model change reports.

9.19F Firms may wish to submit supporting quantitative and qualitative document with their template submission.

Review of the model change policy

9.20 The PRA encourages firms to review the effectiveness of the model change policy on a regular basis to ensure that the internal model continues to reflect the firm's risk profile and meets the T&S. Firms are also reminded that any change to the model change policy itself is subject to the PRA's approval. Readers also are referred to SS12/16, 'Changes to internal models used by UK insurance firms'.[1]

Appendix 1: Template QMC1

The QMC1 template and log file are available at [insert final link when policy finalised, available with CP27/17 at www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-ii-internal-models-update].

1 September 2016; www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-changes-to-internal-models-used-by-uk-insurance-firms-ss.

Appendix 3: Mapping table for model change guidance

To be helpful to readers, the table below shows where guidance relating to model change can be found on the Bank of England website.

Date	Title	URL
21 September 2016	Solvency II: Changes to internal models used by UK insurance firms - SS12/16	www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-changes-to-internal-models-used-by-uk-insurance-firms-ss
25 October 2016	Solvency II: Monitoring model drift and standard formula SCR reporting for firms with an approved internal model – SS15/16	www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-monitoring-model-drift-and-standard-formula-scr-reporting-ss
25 November 2016	Solvency II: internal models – assessment, model change and the role of non-executive directors – SS17/16 (Chapter 9)	www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-internal-models-assessment-model-change-and-the-role-of-non-executive-directors-ss
5 July 2017	Dealing with a market turning event in the general insurance sector – SS5/17 (paragraphs 4.3-4.6)	www.bankofengland.co.uk/prudential-regulation/publication/2017/dealing-with-a-market-turning-event-in-the-general-insurance-sector-ss