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EUMAEUS Concerns About CP 13/18

We are writing to express our views on the PRA consultation paper CP 13/18, published July 2 2018.

We have advised Leasehold Knowledge Partnership on their CP 13/18 submission, so we will not repeat the comments or concerns expressed there, although we share them.

Our comments are as follows.

1. It is a worry that the consultation as a whole has taken such a long time. The Dowd report 'Asleep at the Wheel' identified a number of letters going back to October 2014 and resulting in a stream of consultation papers, discussion papers and supervisory statements (see, e.g., CP 48/16, CP 23/17, CP 24/17, DP 1/16 and SS 3/17) expressing concerns on ERM valuation. Yet the valuation issue is a simple one: once the decrements have been quantified using standard longevity modelling, the ERM valuation model embeds a simple European put option. Clearly the deferment rate concept has caused an intellectual challenge for some, but it is a natural consequence of modern derivative pricing theory, which dates back more than 40 years. The PRA has apparently confirmed this assessment in judging that the valuation changes are not a consequence of Solvency II, but should have been applied all along. Yet during this extended consultation period the ERM market has grown significantly and the PRA has approved the raising of sub-debt and tier 3 debt, not to mention dividend payments, all based on valuation models it has known to be flawed. Investors could rightly complain that they have been misled.

2. There is no consideration of capital treatment for ERMs. This issue could have a further and material impact on the market, yet the PRA has not shown its thinking here. House price exposure leads to autocorrelation risk, which is not easy to model in a Solvency II world in which the market supposedly loses its memory after a year. But an autocorrelated market does not lose its memory: a period of decline is often followed by a further period of decline, which leads to more decline and so on. This autocorrelation provides little opportunity for firms to re-capitalise, and could have a damaging effect on the UK insurance industry. It is remarkable that the PRA has allowed this problem to go unaddressed for so long.

3. We are also concerned about the way ERMs are still being shoehorned into the Matching Adjustment regime. This regime makes balance sheets impenetrable. We spent many hours unravelling the effect of different discount rates, understanding transitional arrangements, comparing regulatory balance sheets with statutory ones etc. Not only us: analysts we have met have mentioned the same difficulty. We appreciate that Solvency II is a transposition of a European regime, but that regime may end with Brexit. We believe the PRA should make it a priority to work on possible reforms to Solvency II or on a UK successor to Solvency II to bring it into line with accounting standards such as IFRS.

4. On the same note, it seems clear that IFRS 17 is not consistent with the regulatory accounting treatment of Solvency II. This inconsistency creates the potential for a gap between the regulatory and statutory balance sheets. The PRA should be working on a consistent treatment, and a single regulatory and statutory accounting standard.

We appreciate that some of these points relate to wider issues raised by Solvency II, but the PRA itself has done little to disentangle the narrower issues of ERM valuation from broader Solvency II concerns.

Yours,

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