BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP14/15

Solvency II: treatment of sovereign debt in internal models

March 2015

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Responses are requested by Friday 1 May 2015.

Please address responses, comments or enquiries to:
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1. Introduction

1.1. This consultation seeks feedback on a draft supervisory statement which sets out the Prudential Regulation Authority's (PRA) expectations of firms in relation to treatment of sovereign debt in internal models.

1.2. The draft supervisory statement is addressed to UK Solvency II firms and to Lloyd's.

1.3. The purpose of this statement is to ensure that firms using an internal model take into account material risks associated with sovereign debt. It is intended to support compliance with Solvency II regulations, thereby achieving the benefits of policyholder protection envisaged by the Directive. Some firms may need to hold additional capital as a result, although the PRA would not regard them as incremental to those costs of complying with Solvency II.

1.4. Solvency II is a maximum-harmonising Directive, therefore the PRA has limited scope to choose an alternative approach. This statement, however, could facilitate effective competition by ensuring that material risks associated with sovereign debt are assessed and reflected in the Solvency Capital Requirement on a consistent basis across firms using internal models.

1.5. This consultation closes on 1 May 2015. Responses should be sent to CP14_15@bankofengland.co.uk

Draft Supervisory Statement: Solvency II: treatment of sovereign debt in internal models

1. Introduction

1.1 This draft supervisory statement is addressed to UK Solvency II firms and to Lloyd's. The Prudential Regulation Authority (PRA) expects firms to read this statement alongside all relevant European legislation and the Solvency Capital Requirement Parts of the PRA Rulebook[1].

1.2 This statement expands on the PRA's general approach as set out in its insurance approach document[2]. By setting out the PRA's expectations of firms in relation to the treatment of sovereign debt in internal models, this draft supervisory statement promotes the safety and soundness of the firms it regulates and contributes to securing appropriate degree of protection for policyholders.

1.3 For the purpose of this statement, sovereign debt refers to exposures in the form of bonds and loans issued or guaranteed by counterparties including but not limited to:

a. central banks;
b. central governments and
c. supranational organisations.

1.3 The PRA has considered matters to which it is required to have regard, and it considers that this statement is compatible with the Regulatory Principles and relevant provisions of the Legislative and Regulatory Reform Act 2006. This statement is not expected to have any direct or indirect discriminatory impact under existing UK law.

[1] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2015/ps215.pdf

[2] The Prudential Regulation Authority's approach to insurance supervision, June 2014; www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf

2. Compliance with Solvency II requirements

2.1 Solvency Capital Requirement - General Provisions 3.3 requires that the Solvency Capital Requirement must be calibrated so as to ensure that all quantifiable risks to which a firm is exposed are taken into account. The PRA considers that sovereign debt as an asset class can give rise to market risk and credit risk as defined in the Glossary Part of the PRA Rulebook. The PRA also expects firms to consider a particular basis risk that arises under Solvency II when sovereign bonds are used to back liabilities. Specifically, the discounting of liabilities with a 'risk-free rate' derived from interest rate swaps may give rise to a risk that the spread between sovereign bond yields and the risk-free rate fluctuates ('gilt-swap spread risk'), leading to mismatch between assets and liabilities.

2.2 Firms should include these risks, where material, in their internal model. Failure to include material risks within the scope of the internal model will mean that the model does not fulfils the requirements set out in Solvency Capital Requirement - Internal Models 10-15.