BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Director Life/General Insurance
Prudential Regulation Authority

16 September 2015

Solvency II Directors' update

With only 3 months to go before the implementation of Solvency II, the PRA's priority is to review applications for Solvency II approvals and inform firms of the outcome of these decisions. Later this month, Sam Woods (Executive Director, Insurance), will provide a further communication which sets out the decision making process and timescales, including for matching adjustment and internal models. Firms are reminded that they should have developed a contingency plan in case any of their applications are rejected and this should include planning for any interdependencies between approvals. Sam's communication will also provide some more information on the capital add-on process and regulatory reporting feedback from the preparatory phase.

Transitional Deduction to Technical Provisions

The PRA has previously communicated its support for firms' use of transitional measures set out in the Solvency II Directive, including Transitional Deduction to Technical Provisions (TDTP). In a speech to the ABI in July, Sam Woods made clear that the PRA would allow full use of transitional measures by those firms that qualify to use them, and that the transitional asset created by the TDTP would qualify as Tier 1 capital. The Annex to this letter provides further details of the PRA's expectations of firms with regard to their management of TDTP, including clarification of the scope of liabilities eligible for TDTP relief and the circumstances under which firms might seek PRA approval to recalculate the TDTP relief.

Standard formula

Firms are reminded of their obligation to carry out a standard formula appropriateness assessment, which should examine the significance with which the risk profile of the firm deviates from the assumptions underlying the solvency capital requirement as detailed in Article 101(3) of the Solvency II Directive. The PRA is continuing to carry out reviews of firms' appropriateness, and firms' assessments will form part of this exercise.

The PRA expects the main conclusions and key outcomes of the assessment to be included as part of the Own Risk and Solvency Assessment report. To date, the quality of these assessments has varied and several have not met the standards required.

The assessment should:

- be both quantitative and qualitative and include an analytical assessment of each material risk module within the standard formula against the firm's own risk profile;
- correspond to the Value-at-Risk of the basic own funds of an insurance or reinsurance undertaking subject to a confidence level of 99.5% over a one-year period;
- compare EIOPA's assumptions underlying the standard formula calibration versus the firm's own risks; and
- include a quantitative assessment of any risks that are not included in the standard formula.

Firms may need to consider using an economic capital model or a series of stress and scenario tests in order to make this assessment.

Segmentation of UK Motor Insurance

The July Directors' Update included information on the Segmentation of Motor Insurance Policies. While this message was in the context of motor insurance policies, the PRA notes that the requirement to report business by Solvency II line of business applies to all classes of business. Within the Solvency II regulatory reporting, firms must report their business as set out in the Solvency II requirements. The PRA has also asked that firms report internal model outputs to us in a separate exercise.

The PRA recognises the difficulties which some firms may face to split their internal model results by Solvency II line of business where their internal model lines of business contain more than one Solvency II line of business. The PRA is considering the impact on firms of splitting the internal model outputs and are planning to issue revised instructions.

Senior Insurers Managers regime

On 25 August 2015, Sam Woods wrote to all insurance firms to articulate the path towards implementation of the Senior Insurance Managers Regime following publications on 13 August 2015. The PRA has also published a one-page summary 'SIMR – what firms need to know and do'.

The letter and summary are available on the PRA's dedicated Strengthening Accountability webpage.

Yours sincerely

Andrew Bulley
Director, Life Insurance

Chris Moulder
Director, General Insurance

Solvency II: Transitional Deduction to Technical Provisions

Scope of Eligible Liabilities

The PRA's expectation is that the application of TDTP is limited to business that is in force prior to 31 December 2015. However, situations may arise whereby liabilities arising from business written prior to Solvency II implementation are transferred to a third party after 1 January 2016, and the PRA are aware that firms are seeking clarification as to the eligibility for TDTP relief within the transferee.

Part VII Transfers

Approval for use of TDTP relief is remains with the legal entity which sought the approval. For business transferred under Part VII of the FSMA, any associated TDTP relief which applied within the ceding firm will not therefore be automatically transferred with the liabilities. Both the transferor and transferee should consider how their risk profile has changed.

Where the business transferred is material and should the transferee firm seek to benefit from TDTP relief in respect of the transferred business, our view is that an application to update the value of technical provisions, and hence the TDTP relief, would be reasonable given that the business transferred was written before 1 January 2016.

Furthermore the PRA's expectation is that the transferor will also need to seek approval to update its value of technical provisions used to calculate the TDTP relief. The value of the TDTP relief within the transferor would therefore be expected to decrease, reflecting the reduction in business in force.

The PRA note that the amount of TDTP relief in respect of liabilities not subject to the transfer may also change as a result of the transaction. This might arise where the transaction results in a change to the assumptions underlying the technical provisions (e.g. expenses), or the balance of risks in the non-hedgeable SCR and hence risk margin.

Reinsured Business

The reinsurance of risks arising from liabilities can result in a similar economic impact to the transfer of business to a third party. A reinsurance arrangement and transfer of business are, however, not equivalent transactions. The reinsurance arrangement is a new contract written by the reinsuring entity which transfers risks, with the original contract remaining in force between the cedant and their policyholder(s).

Where reinsurance materially changes the value of technical provisions used to calculate TDTP relief in the cedant, our expectation is that the cedant will seek approval to update the calculation of technical provisions and hence the TDTP relief credited.

Our expectation is that there may be circumstances under which it would be reasonable for the reinsurer to seek approval to update its calculation of TDTP relief given the expected increase in technical provisions which would result from the transaction. However, given the wide variation in the nature of reinsurance arrangements, firms should discuss the position with their PRA supervisory team, and we will need to make a decision on a case-by-case basis considering the specific details of the proposed transaction.

Updating of Technical Provisions and TDTP relief

The Solvency II Directive makes provision for firms to update the technical provisions used to derive TDTP relief:

> *"Subject to prior approval by or on the initiative of the supervisory authority, the amounts of technical provisions, including where applicable the amount of the volatility adjustment, used to calculate the transitional deduction referred to in paragraph 2(a) and (b) may be recalculated every 24 months, or more frequently where the risk profile of the undertaking has materially changed."*

Should a firm wish to apply for approval to recalculate its TDTP more frequently than every 24 months, it will need to present evidence to the PRA of a material change in risk profile.
Our view is that, in addition to the transfer, (in or out) or reinsurance of existing business specifically discussed above, a variety of circumstances might give rise to a material change in risk profile. These might arise from changes in operating conditions, including falls in interest rates leading to revised market risk exposures, or crystallisation of an insurance risk exposure e.g. a change in projected mortality experience.

Management of the Run-Off of TDTP relief in future years

The Solvency II Directive specifies a 16-year linear run off for TDTP relief.

Capital Releases

Where firms are reliant on TDTP relief in order to cover their solvency capital requirement, they will be required to submit a phasing in plan to the PRA.
The use of transitional measures, regardless of whether or not they are needed to cover the SCR, will therefore not prevent firms from paying dividends or releasing capital from subsidiaries.
Firms reliant on TDTP to cover their SCR will, however, be expected to be able to demonstrate that their capital position is sustainable under a range of operating conditions after allowing for any capital distributions and TDTP run off. This is likely to take the form of an updated phasing in plan, and firms will need to evidence adequacy of capital resources, stress-testing analysis and a medium term capital plan before the PRA can approve any capital distribution.

Run off of TDTP compared with technical provisions

Firms are expected to allocate the aggregate TDTP relief by class of business and these lines of business may run off faster or slower than the 16 years for TDTP. Where the liabilities run off more quickly this could lead to firms carrying a significant TDTP for business which is no longer in force or has substantially reduced volumes. Alternatively the TDTP could run off more quickly that the associated liabilities. In this instance there may be a strain on the emergence of surplus and consequent expected deterioration in the solvency position of the firm.
The PRA therefore expects firms as part of their risk management carefully to consider:

- the projected risk profile relative to that implicit in the initial application for TDTP; and,
- the adequacy of technical provisions net of any TDTP relief.

The PRA's expectation is that the TDTP credit relative to the technical provisions for business remaining in force will be monitored on a continuing basis in firms' Own Risk and Solvency Assessments (ORSA).

If a firm's ORSA highlights the risk that the TDTP may become disproportionately large, because of differences in the rate of run off of the business and TDTP, or if the surplus emerging from the business is not sufficient to support the projected TDTP run off, we would expect the firm to set out how this risk will be managed. Possible mitigants could include restricting the amount of TDTP asset or setting up a provision to cover the potential shortfall.

Timetable of activity Jul 2015 to 2015 Q3

Date	Description
September	ED letter: clarifying the PRA's communication process for Solvency II approvals, update on regulatory reporting and the capital add-on process
September	Letter: information for smaller firms due to submit Solvency II reporting for the first time in 2016
September	Event: PRA Solvency II regulatory reporting industry working group
22 October	Event: regulatory reporting event for smaller insurers (category 4 and 5)
October	Letter: Directors' update
October	Publication: supervisory statement on internal model approval process data review findings
October	Publication: final supervisory statement on reporting and public disclosure - options provided to supervisory authorities
October	Publication: final supervisory statement on applying EIOPA Set 2, System of Governance and ORSA Guidelines
October	Publication: final supervisory statement on third-country insurance and pure reinsurance branches
November	Publication: consultation paper on external audit

Solvency II web updates since the last Directors' update

August 2015

On 28 August 2015, the PRA published two consultation papers and a supervisory statement for all UK firms within the scope of Solvency II:

CP30/15: Solvency II: applying EIOPA Set 2, System of Governance and ORSA Guidelines seeks feedback on a draft supervisory statement that sets out the PRA's expectations of firms and its general approach to EIOPA's Set 2 Solvency II Guidelines, the System of Governance and Own Risk and Solvency Assessment (ORSA) Guidelines.
CP30/15: Solvency II: applying EIOPA Set 2, System of Governance and ORSA Guidelines

CP31/15: Solvency II: third-country insurance and pure reinsurance branches consults on revisions to Supervisory Statement 10/15 'Solvency II: third-country branches' concerning the PRA's approach to third-country insurance and pure reinsurance branches under the Solvency II Directive.
CP31/15: Solvency II: third-country insurance and pure reinsurance branches

SS38/15: Solvency II: consistency of UK generally accepted accounting principles with the Solvency II Directive sets out the PRA's expectations of firms which are considering applying the derogation within Article 9 (4) of the Commission Delegated Regulation (EU) 2015/35 ('the Solvency II Regulation'). This derogation permits a firm to value some assets and liabilities using local generally accepted accounting principles (GAAP) if they fulfil some very specific criteria listed in that Article.
SS38/15: Solvency II: consistency of UK generally accepted accounting principles with the Solvency II Directive

On 17 August 2015, the PRA published two supervisory statements (SS) following consultation in CP20/15:
SS36/15 – *Solvency II: life insurance product reporting codes* sets the list of codes which the PRA expects firms to use when reporting information on life business or annuities stemming from non-life business at product level.

SS37/15 – *Solvency II: internal model reporting codes and components* sets out how the PRA expects internal model and partial internal firms to derive the 'unique number of component' for each component of the internal model.
Firms should review both supervisory statements in addition to CP25/15, published on 10 August 2015 (see below).
SS36/15 – Solvency II: life insurance product reporting codes
SS37/15 – Solvency II: internal model reporting codes and components

On 14 August 2015, the PRA provided clarification for intra-group reinsurance of matching adjustment business.
Solvency II: intra-group reinsurance of matching adjustment business, August 2015

On 13 August 2015, the PRA published policy that sets out how it will hold senior managers in insurance companies to account. The new Senior Insurance Managers Regime replaces the current Approved Persons Regime. Relevant individuals currently approved under the APR can grandfather into equivalent functions in the SIMR provided a grandfathering notification is received by 8 February 2016. The publications and further information and materials for implementation are available on the dedicated 'Strengthening Accountability' webpage.
strengthening accountability

On 10 August 2015, the PRA published a consultation paper on a draft supervisory statement *'Solvency II: reporting and public disclosure - options provided to supervisory authorities'*. The PRA sets out its expectations of firms where it has an option to specify a different approach to that published in the Implementing Technical Standards for the Solvency II reporting templates and Solvency II public disclosure templates. The consultation closes on Monday 21 September 2015.
CP25/15: Solvency II: reporting and public disclosure - options provided to supervisory authorities

As a reminder, on 20 March 2015, the PRA made information available to firms regarding applications for approvals or waivers for Solvency II. As part of this the PRA stated that firms could apply for an exemption to quarterly reporting; firms wishing to apply are reminded to do so by 1 September 2015. Further information on the quarterly reporting exemption is available below and includes links to a waiver application form.
Quarterly reporting exemption

July 2015

On 31 July 2015, EIOPA published the final taxonomy v2.0.0 for Solvency II implementation in 2016. Firms should implement this taxonomy in their reporting systems and should note that there will be a hotfix to this version at the end of September 2015. Further details are available via the link below.
Taxonomy

On 30 July 2015, the PRA provided an update on deferred tax.
Solvency II: update on deferred tax, July 2015

On 24 July 2015, the PRA provided an update on matching adjustment applications.
Solvency II: update on matching adjustment applications, July 2015

On 23 July 2015, the PRA published the following:
A supervisory statement (SS) expanding on the general approach set out in the PRA's approach to insurance supervision. SS30/15 outlines the PRA's expectations of firms in relation to the treatment of sovereign debt in internal models.
SS30/15 - Solvency II: treatment of sovereign debt in internal models

An amendment to supervisory statement SS22/15 - Solvency II: applying EIOPA's set 1 guidelines to PRA-authorised firms. The amendment is to clarify that the statement, where relevant, applies to Lloyd's, including Lloyd's managing agents, rather than just the Society of Lloyd's.
SS22/15 - Solvency II: applying EIOPA's set 1 guidelines to PRA-authorised firms UPDATE

On 14 July 2015, the PRA published an update letter from the PRA's Insurance Directors for all Solvency II-affected firms.
PRA Solvency II: Insurance Directors' update letter, 14 July 2015

EIOPA published the second set of draft Implementing Technical Standards (ITS) and Guidelines for Solvency II. This second set of ITS has been submitted to the European Commission for scrutiny and endorsement. It is expected that both the ITS and Guidelines will be applied from 1 January 2016.
Link to details on set 2 ITS and Guidelines