



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP23/14
Solvency II approvals

October 2014

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Responses are requested by Friday 9 January 2015.

Please address any comments or enquiries to:

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1 Overview

1.1 This consultation paper (CP) seeks views on a draft supervisory statement which sets out the Prudential Regulation Authority's (PRA's) expectations of firms, and provides further clarity in relation to applying for certain Solvency II approvals. It also provides details regarding the PRA's pre-application process for the approval to use the matching adjustment (MA). This statement is of primary interest to all UK insurance firms within the scope of Solvency II, including mutuals, and to the Society of Lloyd's. It is equally applicable to life and general insurers. It is designed to ensure that the PRA meets its statutory objectives of ensuring the safety and soundness of the firms it regulates and to secure an appropriate degree of protection for policyholders.

1.2 The PRA expects firms to read this statement alongside all relevant European legislation, also taking into account the draft rules published in CP16/14: Transposition of Solvency II: Part 3⁽¹⁾ and Paul Fisher's letter Solvency II: Matching adjustment,⁽²⁾ dated 15 October 2014.

1.3 At the time of issuing this CP, the draft Solvency II Regulations (the Delegated Act⁽³⁾ and the Implementing Technical Standards (ITS)) had only been issued in draft format. The guidance issued in this paper is therefore based on the expected content of these Regulations and will be subject to change depending on the final versions. The PRA will communicate any changes as appropriate.

Statutory obligations

1.4 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⁽⁴⁾ and relevant provisions of the Legislative and Regulatory Reform Act 2006.⁽⁵⁾ The PRA has considered equality and diversity issues and has not identified any impact arising from this statement.

1.5 The PRA has also assessed whether the content of this CP facilitates effective competition in markets for services provided by PRA-authorised persons in carrying on regulated activities, in light of the introduction of its secondary competition objective. The supervisory statement applies the standards required by the Solvency II Directive⁽⁶⁾ and draft Solvency II Regulations. As a result, the PRA does not expect incremental costs or benefits to arise. The statement is designed to assist firms to prepare for the implementation of harmonised capital standards anticipated under Solvency II. The PRA therefore considers the content of this CP as compatible with the facilitation of effective competition.

Responses and next steps

1.6 This consultation closes on Friday 9 January 2015. Views are welcomed on the proposals made in this CP and responses should be sent to CP23_14@bankofengland.co.uk.

1.7 As previously communicated, the PRA will publish a Solvency II policy statement with feedback, which includes the final supervisory statements, in 2015 Q1.

(1) Published in August 2014, available at www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1614.pdf.
 (2) Dated 15 October 2014, available at www.bankofengland.co.uk/pradocuments/solvency2/matchingadjustmentletteroct2014.pdf.
 (3) Delegated Act http://ec.europa.eu/internal_market/insurance/solvency/solvency2/index_en.htm.
 (4) Section 3B of FSMA 2000. In particular, Section 3B(1)(b) which provides that the principle that a burden or restriction which is imposed on a person, or, on the carrying out of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.
 (5) www.legislation.gov.uk/ukpga/2006/51/pdfs/ukpga_20060051_en.pdf.
 (6) Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast) (Text with EEA relevance). <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1412873282412&uri=CELEX:02009L0138-20140523>.

2 Draft supervisory statement on Solvency II: Solvency II approvals

Purpose

2.1 This draft supervisory statement is of primary interest to all UK insurance firms within the scope of Solvency II, including mutuals, and to the Society of Lloyd's. It is equally applicable to life and general insurers. It sets out the PRA's expectations of firms and provides guidance on the following Solvency II approvals:

- internal model;
- matching adjustment (MA), ancillary own funds (AOF) and undertaking specific parameters (USP); and
- other solvency II approvals including: exclusion of an entity from the scope of group supervision; single group own risk and solvency assessment (ORSA); and solvency and financial condition report (SFCR) dispensation.

2.2 This statement also provides information on the PRA's expectations and provides further guidance on the:

- Calculation method for the group solvency capital requirement.

2.3 The PRA intends to issue a further communication in November 2014 on other Solvency II approvals which are not discussed in this document. These may include:

- transitional measures on technical provisions;
- transitional measures on the risk-free interest rate; and
- volatility adjustment (VA), pending a decision by HM Treasury regarding its preferred approach to the VA.

2.4 Chapter 3 of this statement introduces the PRA's pre-application process for MA. Although not mandatory, firms wishing to apply to use the MA are strongly encouraged to participate in this process as it will allow the PRA to determine whether a firm's draft application for MA approval would be likely to meet the requirements of the formal application process and to provide feedback to firms where the PRA considers more work is required.

Applications for Solvency II approvals

2.5 Firms can formally submit applications to the PRA for Solvency II approvals from 1 April 2015. Prior to submitting an application the PRA encourages firms to discuss the approvals they intend to apply for with their usual supervisory contact.

2.6 For all Solvency II approvals, the PRA will consider applications against the criteria set out in the Solvency II Directive and Solvency II Regulations and inform the firm of its decision. As the PRA can reject an application for a Solvency II approval, firms should have a contingency plan in place in case the application is rejected. This should include any wider impact on other aspects of Solvency II implementation, for example, the internal model.

2.7 Where the PRA is the group supervisor, the PRA will consult the relevant members of the college of supervisors and take into account their views as part of reviewing group applications. The PRA also expects to have input into the group application processes where the PRA is part of a college of supervisors led by a group supervisor from another Member State.

2.8 Once the PRA has received applications for approvals, further information regarding good practice may be considered useful or necessary for firms and the PRA will communicate accordingly.

Dependencies between approvals

2.9 Firms submitting applications for multiple Solvency II approvals, including for the internal model, are expected to understand any dependencies between the applications and how these may affect the order in which they submit their applications. In addition, as a result of the relationship which exists between certain approvals, firms are also expected to have a contingency plan in case they do not receive approval for applications where dependencies exist, for example:

- firms applying to use the MA may consider another measure as an alternative;
- where firms apply for any of the transitional measures at the same time as applying for the MA and/or VA, the PRA expects firms to provide sensitivity tests showing the impact

on the transitional measure(s) if their applications for the other adjustments are approved or rejected; and

- where a group submitting an internal model application is intending to use the deduction and aggregation method (method 2) for the group solvency calculation, or intending to apply to exclude an entity from the scope of group supervision, consideration should be given to the impact on the group internal model application if these applications are rejected.

Internal model approval and matching adjustment

2.10 Some firms applying for internal model approval may have a dependency on the approval to use the MA. Firms should consider the impact on the internal model if the MA application is rejected. This includes but not limited to, modelling of individual risk factors, proxy modelling techniques (including loss functions and identification of the biting scenario), and, the solvency capital.

Internal models

2.11 Firms intending to submit an application for internal model approval should refer to the draft Solvency II Regulation on the internal model approval processes for information on how to submit a formal internal model application. EIOPA is expected to publish an internal model application template which the PRA will require all firms to use for their formal internal model applications. In the interim, firms in the pre-application process can continue to use the existing PRA self-assessment template (SAT),(1) and will be expected to transpose data onto the new EIOPA template when they make their formal application. The PRA will not be updating the SAT to align with EIOPA's application template.

2.12 All internal model firms are expected to produce a contingency plan in case the PRA rejects an internal model application. Firms are encouraged to discuss and agree this plan with their normal supervisory contact.

Matching adjustment, ancillary own funds and undertaking specific parameters

2.13 The draft Solvency II Regulations set out the legal requirements of the application process for the MA, AOF and USP. This section sets out the PRA's expectations of firms and provides guidance on applications for these approvals.

2.14 The timescales for the PRA to decide whether a firm's application for one of these approvals is complete and then whether to approve or reject the application are detailed in the draft Solvency II Regulations and the draft rules in CP16/14: Transposition of Solvency II: Part 3.

2.15 When submitting an application for these approvals, firms are required to inform the PRA of any other approvals for which they have applied. The PRA encourages firms to also include details of other approvals for which they intend to apply during the next 12 months.

2.16 For the approvals discussed in this section, the PRA has produced a checklist which firms should use when submitting their applications. These checklists are designed to help firms submit the necessary information to allow the PRA to consider the application and avoid delays that may arise from incomplete applications. The application checklists are based on requirements set out in the Solvency II Directive, and the draft Solvency II Regulations. These checklists may need to be revised to reflect the final Solvency II Regulations.

Matching adjustment

2.17 Under Article 77(b) of the Solvency II Directive firms may apply for approval to use a MA. The application checklist for MA will be issued by the end of November 2014. The PRA's detailed expectations regarding MA applications are set out in the letter from Paul Fisher on Solvency II: Matching adjustment, dated 15 October 2014.

2.18 Firms wishing to apply to use the MA can submit a formal application after 1 April 2015. Those firms that participate in the MA pre-application process are also expected to provide the PRA with a detailed breakdown of any changes that have occurred since pre-application.

2.19 The MA calculation requires a fundamental spread to be assigned to each asset based on the credit quality, duration and asset class. Where firms have unrated assets, and have rated these assets using an internal rating system, the PRA may consider undertaking a review of the process followed to produce the internal rating to determine its appropriateness.

2.20 EIOPA is still considering how the MA will be reflected in the group solvency calculation. Until there is further clarity from EIOPA the PRA is unable to comment on how the MA is expected to work at the group level.

Ancillary own funds

2.21 Under Article 90 of the Solvency II Directive, firms may apply to the PRA for approval to recognise AOF when determining own funds. The application checklist for AOF is in the Appendix.

2.22 The Solvency II requirements regarding AOF applications are designed to ensure that firms only receive approval when they can provide robust supporting evidence regarding the:

(1) Dated February 2012, available at www.bankofengland.co.uk/pr/Documents/solvency2/soliiselfassesstemp.xls.

- loss absorbing capacity of the basic own fund item into which the AOF would convert upon call;
- ability and willingness of the counterparties to pay when called upon; and
- recoverability of funds (including the existence, or not, of any legal impediments to payment and whether collateral is held).

2.23 Since the AOF must be callable on demand, firms will also need to demonstrate that there is no trigger event or restrictions affecting when the AOF item can be called.

2.24 The PRA does not expect firms to treat AOF items as emergency capital to be applied for when a firm is in danger of breaching its SCR. In such a situation, raising basic own funds is likely to be a more appropriate action. AOF should be considered as part of a firm's medium term capital management planning. As such, the PRA will expect firms to submit their medium term capital management plan as part of any AOF application.

Undertaking Specific Parameters

2.25 Under Article 104(7) of the Solvency II Directive, firms may apply to the PRA to use USPs when calculating their SCR using the standard formula. Firms are encouraged to submit the application checklist (see Appendix) as this will help to ensure firms meet the requirements of the Solvency II Directive.

2.26 The use of USPs is designed to ensure firms' SCR is being measured appropriately and firms should consider whether the USP is a more accurate reflection of risk. As part of the decision making process the PRA will be considering the reasons why a firm has decided to apply to use USPs and whether they have been applied appropriately across a firm's business.

Other Solvency II approvals

2.27 This section sets out the PRA's expectations of firms and provides guidance on applications for the following:

- exclusion of entity from scope of group supervision;
- single group Own Risk and Solvency Assessment (ORSA); and
- SFCR dispensation.

2.28 For the approvals discussed in this section, the PRA intends to apply the following timeframes:

- within 30 days of receiving the application confirm whether or not the application is complete; and

- within six months of receiving a completed application communicate, in writing, the decision to approve or reject the application.

2.29 If during the review it is established further information is required from the firm, the PRA will request this information in writing. This may delay the decision on the approval application.

2.30 For all approvals discussed in this section, the PRA has produced an application checklist. These checklists are not mandatory but firms are encouraged to complete them to help ensure they have submitted the necessary information for the PRA to consider the application and avoid delays that may arise from incomplete applications.

Exclusion of entity from scope of group supervision

2.31 Article 214 of the Solvency II Directive allows the PRA, in consultation with other concerned supervisory authorities, to exclude an entity from the scope of group supervision. The application checklist to exclude an entity from scope of group supervision is in the Appendix.

2.32 If the PRA decides that an entity is to be excluded from the scope of group supervision under Article 214, then the provisions in the Solvency II Directive will not apply to that entity. However, the group should ensure that any risks which that excluded entity may pose to the rest of the group are adequately identified and managed. Those risks should be reflected in the ORSA and the capital adequacy assessments of group entities that are at risk (including modelled assessments).

Single group ORSA

2.33 Under Article 246 of the Solvency II Directive, a group can apply to produce a single ORSA report which covers the group and the firm-level ORSA for all the firms in the group.

2.34 Groups that wish to apply for the single ORSA report are encouraged to complete the application checklist in the Appendix which details:

- the group's motivation for producing a single ORSA report;
- how the group Board has sought to ensure that all solo risks are individually identifiable in the single ORSA; and
- how the single group ORSA submission presents a true picture of solo entity solvency.

2.35 If permission is granted to produce a single ORSA report covering the group and the firm-level ORSA findings, the group will be required to submit the single ORSA report at the same time to the group supervisor and all the relevant supervisory authorities whose firms report their ORSA findings

in the single ORSA report. The exercise of that option shall not exempt the firms concerned from the obligation to ensure that the requirements of Article 45 of the Solvency II Directive are met. For clarity, firms still need to carry out a full ORSA and provide output of this process to the group for inclusion in the single ORSA report, rather than share its full output with their solo supervisor.

2.36 For groups intending to seek approval for a single ORSA report covering the group and the firm-level ORSA findings, the PRA encourages them to provide a draft single ORSA report as part of their application process based on the forward-looking assessment of own risks (FLAOR) performed by groups during the EIOPA preparatory phase in 2014 and 2015.

SFCR dispensation

2.37 Under Article 53 of the Solvency II Directive a firm can apply to the PRA for reporting exemptions, allowing them to exclude certain information from their SFCR, for example, the public narrative report. The application checklist is in the Appendix.

2.38 Under Article 256 of the Solvency II Directive, groups may also apply to the PRA for this exemption. Groups that wish to apply for non-disclosure are also encouraged to submit the application checklist in the Appendix.

Calculation method for group solvency capital requirement

2.39 Under Article 220 of the Solvency II Directive, the Member State as group supervisor may decide to require

groups to calculate their group capital requirements using the deduction and aggregation method ('method 2') instead of the default accounting consolidation-based method ('method 1'), or to use a combination of method 1 and method 2.

2.40 If groups do not think that the exclusive use of method 1 is appropriate and therefore propose to use method 2, or a combination of method 1 and method 2, the PRA expects groups to indicate this by submitting the form in the Appendix. This form includes the necessary information the PRA needs to make its decision on the choice of calculation method and includes, the financial and solvency position of subsidiaries, availability of data, and rationale for using an alternative to method 1.

2.41 The PRA will review the submission from groups and, where applicable, in co-operation with the college of supervisors, decide on whether the exclusive use of method 1 is appropriate and whether to allow groups to use method 2, or a combination of the two. The PRA will make its decision based on the factors outlined in the draft Solvency II Regulations. As part of this assessment, the PRA expects to review the impact of the use of method 2 or a combination method on capital surplus, own funds availability, and the inter-connectedness of any entity for which method 2 would be used and the rest of the group.

2.42 On receipt of an application form for method 2 or for a combination of methods 1 and 2, the PRA aims to consider the information and respond to the firm in writing within a period of six months.

3 Matching adjustment pre-application process

3.1 The PRA has already advised firms of its intention to conduct a pre-application process for matching adjustment (MA) approval.⁽¹⁾ This intention has been reinforced by the results of the MA trial submission exercise held in the summer 2014. The PRA encourages firms who intend to apply to for MA approval to refer to Paul Fisher's letter on Solvency II: Matching adjustment issued on 15 October 2014, which answers several questions from firms on the interpretation of the eligibility criteria in Article 77(b) of the Solvency II Directive and the nature of the evidence the PRA expects firms to submit to demonstrate compliance with these criteria. It also provides feedback on the recent MA trial submission exercise and the associated PRA expectations for the MA pre-application process.

3.2 The pre-application process will allow the PRA to determine whether a firm's draft application for MA approval would be likely to meet the requirements of the formal application process and to provide feedback to firms where the PRA considers more work is required. It will also allow firms that are developing an internal model, and therefore have a dependency between the two approvals, to understand as early as possible whether the PRA would be minded to reject the MA application in its current form. In this case, firms will be able to plan remedial action, including any associated changes required to contingency plans. Although it is not mandatory for firms to enter the pre-application process for MA in order to submit a formal application, firms are strongly encouraged to participate.

Approach to matching adjustment pre-application

3.3 Firms wishing to participate in the MA pre-application process should complete their submissions in line with the expectations set out for formal application by the Solvency II Directive and draft Solvency II Regulations. Firms should also consider the communications previously issued by the PRA on the MA.⁽²⁾

3.4 Once an MA pre-application has been received, the PRA will confirm receipt of the application to the firm. During the pre-application review, the PRA may have some limited conversations with firms about their submissions. These conversations will be related to any further information that the PRA requires from the firm in order to complete the review.

3.5 The PRA will provide feedback to all firms that have submitted an MA pre-application by 31 March 2015. Each firm will receive specific feedback on its application which may include an indication of whether the application would be likely to be approved if it were submitted formally.

Matching adjustment pre-application process

3.6 Firms that wish to participate in the MA pre-application process should send their submissions to the PRA at S2submissions@bankofengland.co.uk from 1 December 2014 to 6 January 2015. Firms should inform their normal supervisory contact of their intention to participate in the process by 30 November 2014.

(1) PRA Solvency II Insurance Directors' update, June 2014: available at www.bankofengland.co.uk/pradocuments/solvency2/insurancedirectorsupdatejune2014.pdf.

(2) PRA insurance Directors' update, Solvency II — Matching Adjustment Asset Eligibility, June 2014: available at www.bankofengland.co.uk/pradocuments/solvency2/matchingadjustmentasseteligibilityjune2014.pdf.

PRA Solvency II insurance directors' update, Solvency II: an update on implementation, July 2014: available at www.bankofengland.co.uk/pradocuments/solvency2/solvency2updatejuly2014.pdf.

Appendix: Application checklists

Solvency II Approvals

- 1 Ancillary own funds checklist

- 2 Undertaking specific parameters checklist

- 3 Exclusion of entity from scope of group supervision checklist

- 4 Single group own Risk and Solvency Assessment checklist

- 5 Solvency Financial and Condition Report dispensation checklist

- 6 Choice of calculation method checklist