



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY

Consultation Paper | CP3/15

# Solvency II: transitional measures and the treatment of participations

January 2015

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January 2015

This consultation paper proposes changes to the PRA Rulebook, and two supervisory statements, in order to implement the Solvency II Directive.

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Responses are requested by Friday 20 February 2015.

Please address any comments or enquiries to:

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# 1 Overview

1.1 This consultation paper (CP) sets out proposed rules for the Prudential Regulation Authority (PRA) Rulebook necessary to implement the Solvency II Directive (the Directive) in respect of certain transitional provisions. It follows on from CP16/14,<sup>(1)</sup> which anticipated this consultation. It also includes a draft supervisory statement to support the implementation of these transitional measures.

1.2 In addition, this consultation contains a draft supervisory statement that provides further clarity on the internal model treatment of participations for the purposes of calculating the Solvency Capital Requirement (SCR) at solo level.

1.3 The proposals in this consultation are relevant to all UK Solvency II firms and to the Society of Lloyd's. Views are sought on both the draft rules and the draft supervisory statements. The consultation closes on Friday 20 February.

## Statutory obligations

1.4 In discharging its general functions of making rules, and determining the general policy and principles by reference to which it performs particular functions, the PRA must, so far as is reasonably practicable, act in a way that advances its general objective to promote the safety and soundness of PRA authorised firms, and its insurance-specific objective of contributing to securing an appropriate degree of policyholder protection.

1.5 As the PRA is implementing a largely maximum-harmonising Directive, it has limited flexibility in making the relevant rules. If the PRA did not make implementing rules the United Kingdom would not be compliant with the Directive and would risk being subject to infraction proceedings.

1.6 The main objective of Solvency II, as set out in Article 27 of the Directive, is the protection of policyholders and beneficiaries. In advancing the prudential strength of the regulatory regime it will also promote the safety and soundness of insurers. This is consistent with the PRA's statutory objectives.

1.7 In developing the rules proposed in this CP and establishing its practices and procedures, the PRA has had regard to the Regulatory Principles.<sup>(2)</sup> One of the Regulatory Principles is that regulators should exercise their functions as transparently as possible. The PRA has followed this principle

by publishing the supervisory statements alongside the draft rules in order to provide greater clarity for firms about our supervisory expectations.

## Economic impact

1.8 The PRA is also required to perform an economic assessment of the impact of its policy proposals. As the PRA is implementing a largely maximum-harmonising Directive, it has limited flexibility in making the relevant rules, including for the purposes of advancing its secondary competition objective. The cost-benefit analysis of the rules should be considered in this context.

1.9 The PRA has a statutory requirement to state whether the impact on mutuals from proposed rules would be significantly different from the impact on other firms. The proposals in this CP will affect mutuals, and the cost-benefit analysis outlined in Chapter 2 and the draft supervisory statements set out the extent to which mutuals could be affected by the relevant proposals.

1.10 When discharging its general functions in a way that advances its primary objectives the PRA has, as a secondary objective, a duty to facilitate effective competition in the markets for services provided by PRA-authorised persons. The impact on competition in the markets affected by the proposals in this CP is considered in Chapter 2 and the draft supervisory statements.

1.11 However, implementing a maximum-harmonising Directive provides the PRA with limited scope to choose alternative approaches to further its competition objective, and the analysis should be considered in this context.

## Equality and diversity

1.12 The PRA may not act in an unlawfully discriminatory manner. It is also required under the Equality Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions. The PRA has assessed the equality and diversity implications of the policy proposals in this consultation, and they are not expected to have any direct or indirect discriminatory impact under existing UK law.

(1) *PRA Consultation Paper CP16/14*, 'Transposition of Solvency II: Part 3', August 2014; [www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp1614.pdf](http://www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp1614.pdf)  
 (2) Section 3B of the Financial Services and Markets Act 2000 (FSMA).

## Responses and next steps

1.13 This consultation closes on Friday 20 February 2015. The PRA is adopting a short consultation period in order that the final rules and supervisory statements may be published ahead of the EU deadline of 31 March 2015 for transposing the Directive into UK law. Views are welcomed on any of the proposals in this CP. Respondents should send their feedback to the address above, and clearly indicate which proposals they are referring to when giving their feedback.

1.14 The PRA will publish a policy statement, addressing any feedback received to the consultation, along with final rules and supervisory statements following the close of the consultation. This will be published as part of the wider policy statement providing feedback and final rules to implement the Directive in March 2015.

## 2 Transitional measures on risk-free interest rates and technical provisions

2.1 In CP16/14, the PRA consulted on proposed rules to implement the Directive in respect of certain transitional measures. This included transitional measures for own funds, firms in run-off, groups, and for reporting and public disclosure.

2.2 However, the PRA did not consult at that time on transitional measures regarding risk-free rates and technical provisions. This was because the PRA did not have sufficient data to quantify the potential impact of these transitional measures.

2.3 The PRA conducted a data collection exercise in the summer of 2014, and has now analysed the results and assessed the quantitative impact of transposing the transitional measures on risk-free rates and technical provisions. The PRA is now consulting on proposals to implement these measures.

2.4 The transitional measures in Solvency II and the PRA's implementation of these measures are intended to ensure a smooth transition towards the full requirements of the new regime. The purpose of the proposed rules is set out in this CP and the rules are presented in Appendix 1.

2.5 In addition to the proposed rules, the PRA is also publishing a draft supervisory statement to provide further clarity for firms regarding the implementation of some of the transitional measures. This is provided in Appendix 2.1.

### Proposals

#### Transitional measure on risk-free interest rates — Article 308c

2.6 The Directive specifies a transitional measure on risk-free interest rates. Firms may apply to the PRA for approval to transition from their current discount rate requirements to the corresponding Solvency II requirements.

2.7 The transitional measure aims to avoid market disruption potentially associated with the move to a new regulatory regime and to limit interference with the existing availability of insurance products.

2.8 The transitional measure applies for 16 years and is an adjustment to the relevant risk-free interest rate term structure used to discount admissible insurance obligations. The adjustment is calculated as a portion of the difference between the rate that applies under the current regime and the Solvency II discount rate. The proportion reduces linearly over the course of the 16-year period.

#### Transitional measure on technical provisions — Article 308d

2.9 The Directive specifies a transitional measure on technical provisions which firms may apply to the PRA for approval to use to transition from current requirements to Solvency II requirements.

2.10 The transitional measure aims to avoid market disruption potentially associated with the move to a new regulatory regime and to limit interference with the existing availability of insurance products.

2.11 The transitional measure applies for 16 years, and is a deduction from the amount of Solvency II technical provisions. The deduction is calculated as the difference between current technical provisions and Solvency II technical provisions, and decreases linearly over the course of the 16-year transitional period. Further details on the calculation of the adjustment are set out in the draft supervisory statement in Appendix 2.1.

#### Cost-benefit analysis

2.12 The baseline scenario for this cost-benefit analysis is the Solvency II regime excluding the effect of the transitional measures on technical provisions or on the risk-free rate (see CP16/14). Relative to this baseline, the costs and benefits have been described below.

2.13 Implementing these transitional measures will provide firms with more time to meet any incremental capital costs that result from Solvency II. This would avoid the need for firms to take short-term capital raising and/or other management actions, such as asset allocation decisions or wind-down of existing business, that may not be optimal for long-term policyholder protection. Another benefit is that firms can remain in the market and are free to compete, whilst existing policyholders are protected appropriately.

2.14 The main cost is to policyholder protection during the transitional period, although we do not expect this cost to be material. Firms using the transitional measures will have lower financial resources than would be required by the full Solvency II regime, but these resources will not fall below those required under the existing UK regime. This is because the Directive imposes a cap on the amount of transitional benefit a firm may derive, which is set at the level of transitional benefit consistent with maintaining financial resources at least equal to the existing UK regime.

2.15 The PRA has also considered the impact of these proposals on competition in insurance markets. The transitional measures are targeted at the existing business of incumbent firms, enabling them to compete effectively with new entrants. In the absence of these transitional measures, some firms that had written business in the past and managed it in a way compliant with our existing regime would face a shortfall in financial resources compared to higher Solvency II requirements. This would place them at a disadvantage to new entrants simply because of the change in regulatory requirements. To manage this shortfall, firms might have sought to take immediate action such as using new business to cross-subsidise their existing business, or to take other management actions, which might have included running off lines of business or exiting the industry in some cases. This

could potentially harm competition, were the PRA to take no action. The PRA's proposed approach should facilitate effective competition between incumbent firms and new entrants for new business under Solvency II standards, without undermining policyholder protection for existing business.

2.16 This implementation of the transitional measures should not have any different or adverse consequences for mutuals as opposed to proprietary firms. To the extent that the transitional measures mitigate the need for short-term capital raising, then the proposals are likely to benefit mutuals more than other firms, since mutuals face greater constraints in raising new capital.

2.17 The PRA believes the proposals will support stability in the provision of critical financial services in the United Kingdom and other Member States by mitigating disruption to insurance markets associated with the move to a new regulatory regime.

2.18 The PRA considers that the benefits of the proposed rules are proportionate to the costs. The proposals provide a framework for competition that maintains current levels of policyholder protection, while allowing incumbents and new entrants to compete for new business on an equivalent regulatory basis.

# Appendices

## **Appendix 1: Draft PRA Rulebook**

- 1.1 PRA Rulebook — Transitional measures

## **Appendix 2: Draft Supervisory Statements**

- 2.1 Supervisory Statement — Solvency II: transitional measures on risk-free interest rates and technical provisions
- 2.2 Supervisory Statement — Solvency II: the internal model treatment of participations

**PRA RULEBOOK: SOLVENCY II FIRMS: TRANSITIONAL MEASURES AMENDMENT  
INSTRUMENT [2015]**

**Powers exercised**

- A. The Prudential Regulation Authority (“PRA”) makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137G (the PRA’s general rules); and
  - (2) section 137T (general supplementary powers).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

**Pre-conditions to making**

- C. In accordance with section 138J of the Act (Consultation by the PRA), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

**PRA Rulebook: Solvency II Firms: Transitional Measures Amendment Instrument [2015]**

- D. The PRA makes the rules in Annex A and Annex B to this instrument.

**Commencement**

- E. This instrument comes into force on [date].

**Citation**

- F. This instrument may be cited as the PRA Rulebook Solvency Firms: Transitional Measures Amendment Instrument [2015].

**By order of the Board of the Prudential Regulation Authority**

[DATE]

## Annex A

Note: Annex A contains proposed amendments to the Transitional Measures Instrument as consulted on by the PRA in Transposition of Solvency II: Part 3 (CP16/14).

In this Annex, striking through indicates deleted text. All other text is inserted and is not underlined.

## 1 APPLICATION AND DEFINITIONS

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1.2 ...

*adjusted INSPRU 7 technical provisions amount*

means, in relation to a *firm*, the *INSPRU 7 technical provisions amount* increased by such amount, if any, as would have been necessary to enable the *firm* to meet the applicable *Solvency I technical provisions requirements*.

*admissible insurance and reinsurance obligations*

means insurance and *reinsurance* obligations:

- (1) where the contracts that gave rise to the those obligations were concluded prior to the *Solvency II implementation date*, excluding contract renewals on or after the *Solvency II implementation date*;
- (2) where until 31 December 2015, technical provisions for those obligations were determined in accordance with INSPRU 1.1.16R; and
- (3) in respect of which no *matching adjustment* is applied.

**[Note: Article 308c(3) of the *Solvency II Directive*]**

...

*INSPRU 1 technical provisions amount*

means, in relation to a *firm*, an amount equal to its technical provisions after deduction of the amounts recoverable from *reinsurance* contracts, as established in accordance with INSPRU 1.1.12 R to 1.1.19 G of the *PRA Handbook* as at 31 December 2015.

*INSPRU 7 technical provisions amount*

means, in relation to a *firm*, an amount equal to the value of its insurance liabilities after deduction of the amounts recoverable from *reinsurance* contracts, valued in accordance with INSPRU 7.1.15 R and INSPRU 7.1.36 G to 7.1.41 G of the *PRA Handbook* as at 31 December 2015.

...

*phasing-in plan*

means the phasing-in plan required to be submitted by the *firm* to the *PRA* under 12.1.

*pre-Solvency II GCRR*

means the requirement to maintain group capital resources that applied to a *UK Solvency II firm* under *PRA rules* as at 31 December 2015.

*pre-Solvency II overall financial adequacy rule*

means the *rule* in GENPRU 1.2.26R of the *PRA Handbook* as at 31 December 2015 requiring a *firm* to at all times maintain overall financial resources which are adequate to ensure that there is no significant risk that its liabilities cannot be met as they fall due, including any requirement under INSPRU and GENPRU (of the *PRA Handbook* as at 31 December 2015) having regard to any guidance given to the *firm* by the *PRA* about the amount and quality of capital resources that the *PRA* thinks the *firm* should hold at all times to satisfy the requirement in GENPRU 1.2.26R.

*Solvency I technical provisions requirements*

means the requirements relating to the establishment of technical provisions by *firms* contained in Article 15 of the *First Non-Life Directive*, Article 20 of the *Consolidated Life Directive* and Article 32 of the *Reinsurance Directive* on 31 December 2015.

*Solvency II technical provisions amount*

means, in relation to a *firm*, an amount equal to its *technical provisions* after deduction of the amounts recoverable from *reinsurance* contracts and *ISPVs*, calculated in accordance with Technical Provisions 2.1 – 2.3 as at the *Solvency II implementation date*.

*transitional deduction*

means the deduction from *technical provisions* calculated and applied in accordance with 11.

...

## 6 NON-COMPLIANCE WITH THE SCR

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- 6.1 If a firm complies with the *pre-Solvency II MCR* but during 2016 does not comply with the *SCR*:
- (1) Undertakings in Difficulty 3.1(3) shall not apply;
  - (2) the *firm* must take the measures necessary to achieve the establishment of the level of *eligible own funds* covering the *SCR* or the reduction of its risk profile to ensure compliance with the *SCR* by 31 December 2017;
  - (3) the *firm* must, every three *months* submit a progress report to the *PRA* setting out the measures taken and the progress made to establish the level of *eligible own funds* covering the *SCR* or to reduce the risk profile to ensure compliance with the *SCR*.

**[Note: Article 308b (14) of the *Solvency II Directive*]**

- 6.2 6.1 shall cease to apply where a progress report submitted in accordance with 6.1(3) shows that there was no significant progress in achieving the establishment of the level of *eligible own funds* covering the *SCR* or the reduction of the risk profile to ensure compliance with the

SCR between the date of the observation of non-compliance with the SCR and the date of the submission of the progress report.

**[Note: Article 308b (14) of the Solvency II Directive]**

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## 9 GROUPS

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...

9.2 Where Group Supervision 2.1(1) or (2) applies, if a *participating Solvency II undertaking* that is a *firm* or any *relevant insurance group undertaking* complies with the *pre-Solvency II GCRR* but during 2016 does not comply with the *group SCR*:

- (1) Group Supervision 4.4 shall not apply;
- (2) the *relevant insurance group undertakings* must take the measures necessary to achieve the establishment of the level of *eligible own funds* covering the *group SCR* or the reduction of the risk profile to ensure compliance with the *group SCR* by 31 December 2017;
- (3) the *relevant insurance group undertakings* must, every three *months* submit a progress report to the *PRA* setting out the measures taken and the progress made to establish the level of *eligible own funds* covering the *group SCR* or to reduce the risk profile to ensure compliance with the *group SCR*.

**[Note: Art. 308b (17) of the Solvency II Directive]**

9.3 9.2 shall cease to apply where a progress report submitted in accordance with 9.2(3) shows that there was no significant progress in achieving the establishment of the level of *eligible own funds* covering the *group SCR* or the reduction of the risk profile to ensure compliance with the *group SCR* between the date of the observation of non-compliance with the *group SCR* and the date of the submission of the progress report.

**[Note: Art. 308b (17) of the Solvency II Directive]**

## 10 RISK-FREE INTEREST RATES

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10.1 A *firm* may only use the *risk-free interest rate transitional measure* if it has received approval to do so from the *PRA*. Where a *firm* applies the *risk-free interest rate transitional measure*, it must calculate the adjustment for each currency as a portion of the difference between:

- (1) the interest rate as determined by the *firm* in accordance with INSPRU 3.1.28R to INSPRU 3.1.47R of the *PRA Handbook* as at 31 December 2015; and
- (2) the annual effective rate, calculated as the single discount rate that, where applied to the cash-flows of the portfolio of *admissible insurance and reinsurance obligations*, results in a value that is equal to the value of the *best estimate* of the portfolio of *admissible insurance and reinsurance obligations* where the time value is taken into account using the *relevant risk-free interest rate term structure*.

**[Note: Article 308c(2) of the Solvency II Directive]**

10.2 The portion referred to in 10.1 shall decrease linearly at the end of each year from 100% during 2016 to 0% during 2032.

**[Note: Article 308c(2) of the Solvency II Directive]**

10.3 Where a *firm* applies the *volatility adjustment* in accordance with Technical Provisions 4D, the *relevant risk-free interest rate term structure* referred to in 10.1(2) shall be based on the risk-free interest rates adjusted with the *volatility adjustment*.

**[Note: Article 308c(2) of the Solvency II Directive]**

10.4 A *firm* that applies the *risk-free interest rate transitional measure* must:

- (1) not include the admissible insurance and reinsurance obligations in the calculation of the volatility adjustment;
- (2) not apply the *technical provisions transitional measure*;
- (3) as part of its *SFCR* publically disclose that it applies the *risk-free interest rate transitional measure* and the quantification of the impact of not applying the *risk-free interest rate transitional measure* on its financial position.

**[Note: Article 308c(4) of the Solvency II Directive]**

## 11 TECHNICAL PROVISIONS

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11.1 A *firm* may only apply a *transitional deduction* from its *technical provisions* if it has received approval to do so by the *PRA*.

**[Note: Article 308d(1) of the Solvency II Directive]**

11.2 Where the *INSPRU 7 technical provisions amount* is greater than the *INSPRU 1 technical provisions amount*, the *transitional deduction* is the amount corresponding to a portion of the difference between:

- (1) the *Solvency II technical provisions amount*; and
- (2) the *INSPRU 7 technical provisions amount*.

**[Note: Article 308d(2) of the Solvency II Directive]**

11.3 Where the *INSPRU 7 technical provisions amount* is less than the *INSPRU 1 technical provisions amount*, the *transitional deduction* is the amount corresponding to a portion of the difference between:

- (1) the *Solvency II technical provisions amount*; and
- (2) either, at the option of the *firm*:
  - (a) the *adjusted INSPRU 7 technical provisions amount*; or
  - (b) the *INSPRU 1 technical provisions amount*.

**[Note: Article 308d(2) of the Solvency II Directive]**

11.4 The maximum portion referred to in 11.2 or 11.3, as applicable, shall decrease linearly at the end of each year from 100% during 2016 to 0% during 2032.

**[Note: Article 308d(2) of the Solvency II Directive]**

11.5 Where a *firm* applies the *volatility adjustment*, the amount referred to in 11.2(1) or 11.3(1), as applicable, shall be calculated with the *volatility adjustment* on the *Solvency II implementation date*.

**[Note: Article 308d(2) of the Solvency II Directive]**

11.6 A *firm* may only recalculate the amounts under 11.2, 11.3 and the amount of the *transitional deduction* following receipt of approval from the *PRA*.

**[Note: Article 308d(3) of the Solvency II Directive]**

11.7 A *firm* must reduce the *transitional deduction* by any amount that is required to ensure that the financial resources requirements applicable to that *firm* are no lower than under the *pre-Solvency II overall financial adequacy rule* as at 31 December 2015.

**[Note: Article 308d(4) of the Solvency II Directive]**

11.8 A *firm* with approval to use the *technical provisions transitional measure* must:

- (1) not use the *risk-free interest rate transitional measure*;
- (2) as part of its *SFCR* publically disclose that it applies the *transitional deduction* and the quantification of the impact of not applying the *transitional deduction* on its financial position.

**[Note: Article 308d(5) of the Solvency II Directive]**

## 12 ~~NON-COMPLIANCE WITH THE SCR PHASING-IN PLAN~~

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12.1 A *firm* with approval to use the *risk-free interest rate transitional measure* or the *technical provisions transitional measure* must:

- (1) immediately inform the *PRA* as soon as it observes that the *SCR* is no longer complied with without application of the *risk-free interest rate transitional measure* or the *technical provisions transitional measure*
- (2) take the measures necessary to achieve compliance with the *SCR* by 1 January 2032
- (3) within two *months* from the observation of non-compliance with the *SCR* without application of the *risk-free interest rate transitional measure* or the *technical provisions transitional measure*, submit a *phasing-in plan* to the *PRA*.

**[Note: Article 308e(1) and (2) of the Solvency II Directive]**

12.2 A *firm's phasing-in plan* must set out the planned measures to establish the level of *eligible own funds* covering the *SCR* or reduce its risk profile to ensure compliance with the *SCR* by 1 January 2032.

**[Note: Article 308e(2) of the Solvency II Directive]**

12.3 A *firm* that updates its *phasing-in plan* must submit the updated *phasing-in plan* to the *PRA*.

**[Note: Article 308e(2) of the Solvency II Directive]**

12.4 A *firm* with approval to use the *risk-free interest rate transitional measure* or the *technical provisions transitional measure* and that is subject to the requirement in 12.1(3) must submit annually a report to the *PRA* setting out the measures taken and progress made to ensure compliance with the *SCR* by 1 January 2032.

**[Note: Article 308d(5) and 308e(3) of the Solvency II Directive]**

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## Annex B

Note: Annex B contains proposed amendments to the Third Country Branches Instrument as consulted on by the PRA in Transposition of Solvency II: Part 3 (CP16/14).

In this Annex, underlining indicates new text and striking through indicates deleted text.

### 14 TRANSITIONAL MEASURES

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14.1 The following provisions in the Transitional Measures Part apply to *third country branch undertakings* with the modifications set out in 14.2:

- (1) Transitional Measures 1.2 (~~insofar as relevant~~);
- (2) Transitional Measures 3.1;
- (3) Transitional Measures 3.3;
- (4) Transitional Measures 4 – 7; and
- (5) Transitional Measures 10 – 12

14.2 The modifications referred to in 14.1 are:

- (1) any modification set out in this Part to any Parts referred to in the Transitional Measures Part;
- (2) the modifications set out in 10.2
- (3) any reference to “*pre-Solvency II MCR*” is to be interpreted as a reference to *pre-Solvency II branch MCR*; and
- (4) any other necessary modification.



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY

Supervisory Statement | SS[xx]/15

# Solvency II: transitional measures on risk-free interest rates and technical provisions

January 2015

## 1 Introduction

1.1 This supervisory statement is of interest to all UK insurance firms within the scope of Solvency II and to the Society of Lloyd's. In particular, it is relevant to firms that are considering applying for, or that have been granted approval to use, either the transitional measure on the risk-free interest rate or the transitional measure on technical provisions.

1.2 It sets out the calculation and application process to be used for these transitional measures, as specified in chapters 10 and 11 of the Solvency II Firms: Transitional Measures Part of the PRA Rulebook.

1.3 This statement should be read in conjunction with those chapters of the Solvency II Firms: Transitional Measures Part of the PRA Rulebook, the rules in the rest of the Solvency II Firms section of the PRA Rulebook, the Solvency II Delegated Act and with European Insurance and Occupational Pensions Authority (EIOPA) Level 3 Guidelines.

1.4 This statement expands on the PRA's general approach as set out in the PRA's approach to insurance supervision.<sup>(1)</sup> By clearly and consistently explaining its expectations of firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates, and contributing to securing an appropriate degree of protection for policyholders. 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<sup>(2)</sup> and relevant provisions of the Legislative and Regulatory Reform Act 2006.

1.5 The PRA believes the benefits associated with the proposals in this draft supervisory statement are proportionate to the costs. By providing further clarity to firms on the expectations regarding the calculation methodology of the risk-free rate and technical provisions transitionals, the PRA seeks to ensure that firms have sufficient time to meet any incremental capital compliance costs resulting from Solvency II. This would avoid the need for firms to take short-term capital raising and/or other management actions that may not be optimal for long-term policyholder protection.

1.6 The main cost associated with the proposals is that firms using the transitional measures will have lower financial resources than would be required by immediate introduction of the full Solvency II regime. Existing policyholders will thus temporarily have a lower level of protection than would be the case under the full Solvency II requirements, but not below the level of our current requirements.

1.7 The PRA has also had regard to its secondary competition objective and considers that the content of this statement

provides a framework for competition that maintains current levels of policyholder protection, while allowing incumbents and new entrants to compete for new business on an equivalent regulatory basis.

1.8 The proposals in this CP are not expected to have any direct or indirect discriminatory impact under existing UK law.

## 2 Transitional measure on the risk-free interest rate

### Calculation of the single interest rate

2.1 In meeting the requirements of Solvency II Firms: Transitional Measures 10.1(1) and 10.1(2), the PRA expects firms to determine the single interest rate in 10.1(1) in such a manner that the comparison with the annual effective rate in 10.1(2) is meaningful. In their applications, firms are expected to explain and justify the method used.

## 3 Transitional measure on technical provisions

3.1 Under Solvency II, firms may apply to the PRA for approval to make a transitional deduction from technical provisions (a 'transitional deduction'). This chapter sets out the PRA's expectations of the calculation methodology that firms should use for the transitional deduction.

3.2 The scope of this chapter is limited to the calculations a firm must perform to apply the transitional deduction. In the next section, all references to technical provisions, and possible adjustments thereto, are made in the limited context of applying the transitional deduction. Nothing in this supervisory statement should be taken to have any bearing on the technical provisions that a firm is required to calculate for regulatory or reporting purposes. The PRA does not expect any firm to recalculate or restate the technical provisions it uses for regulatory purposes as a result of this statement.

### Calculation of the transitional deduction before application of the limit

3.3 The purpose of the transitional deduction is to enable firms to move to the new Solvency II basis without undue market disruption. In the United Kingdom, firms are currently expected to calculate their insurance liabilities on both a Pillar 1 (INSRU 1) and a Pillar 2 (INSRU 7) basis.

3.4 The PRA's view is that Pillar 2 technical provisions are the most appropriate starting point for the transitional deduction because they represent a firm's own realistic economic valuation of its insurance liabilities. As such, they will capture all relevant features of the liabilities, including those that may

(1) [www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf](http://www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf).

(2) Section 3B of the Financial Services and Markets Act 2000 (FSMA).

not be adequately reflected in a firm's Pillar 1 technical provisions as set out in Chapter 1 of the Prudential Sourcebook for Insurers (INSPRU 1).

### Cases where Pillar 2 technical provisions are greater than Pillar 1 technical provisions

3.5 In cases where the Pillar 2 technical provisions amount is greater than the Pillar 1 technical provisions amount, 11.2 of Solvency II Firms: Transitional Measures, requires firms to use the Pillar 2 technical provisions amount as the basis for the calculation, without any adjustment.

3.6 When calculating the Pillar 2 technical provisions amount, as required under Solvency II Firms: Transitional Measures 11.2(2), firms should use methodologies, assumptions and input data that are consistent with their most recent Pillar 2 technical provisions submission, including any margins held (eg implicit within unearned premium reserves, management margins), or amounts held following guidance given by the PRA or its predecessor, the Financial Services Authority.

### Cases where Pillar 2 technical provisions are lower than Pillar 1 technical provisions

3.7 In cases where the Pillar 2 technical provisions amount is lower than the Pillar 1 technical provisions amount, 11.3 of Solvency II Firms: Transitional Measures, gives firms two options for calculating the transitional deduction. The first option is to use the Pillar 1 technical provisions as the basis.

3.8 The second option is to make a comparison of the Pillar 2 amount with the Solvency I (EU minimum) technical provisions requirements and to make an adjustment to the Pillar 2 amount if necessary.

### Comparing Pillar 2 technical provisions with the Solvency I technical provisions requirements

3.9 The reason for this approach is that the amount used to calculate the transitional deduction cannot be less than the minimum amount of technical provisions that would be required under Article 15 of the First Non-Life Directive, Article 20 of the Consolidated Life Directive and Article 32 of the Reinsurance Directive on 31 December 2015 (the 'EU minimum amount').<sup>(1)</sup> If the Pillar 2 technical provisions amount is less than the Pillar 1 technical provisions amount, there is a risk that using Pillar 2 will result in a calculation that is based on an amount that is less than the EU minimum amount. To simplify the calculation for firms in this position, the draft rules contain an option to use the Pillar 1 technical provisions amount. If pursuing the alternative in Solvency II Firms: Transitional Measures 11.3(2)(a), to use an adjusted Pillar 2 amount, firms should make their own assessment of whether their Pillar 2 technical provisions are at least as great as the EU minimum amount, and submit the conclusions of this assessment within their applications to the PRA.

3.10 By way of example, for non-profit life insurance business, the Pillar 2 technical provisions may be lower than the minimum amount that would be required to comply with Article 20 of the Consolidated Life Directive, because the Pillar 2 technical provisions may not contain an explicit allowance for adverse deviation. In such cases a firm must make its own assessment of the adjustments that would be necessary to ensure that the amount used for the calculation under Solvency II Firms: Transitional Measures 11.3(2)(a) is at least equal to the EU minimum amount.

3.11 In their applications, firms should describe any adjustments they have made, and provide a reconciliation of the Pillar 2 technical provisions amount and the adjusted amount they have used for Solvency II Firms: Transitional Measures 11.3(2)(a).

### Limiting the amount of the transitional deduction

3.12 The limitation under Solvency II Firms: Transitional Measures 11.7, is necessary to ensure that the transitional deduction will not contribute to a reduction in the level of policyholder protection.

3.13 Under Solvency II, the 'financial resources requirements' are the sum of the technical provisions (net of the transitional deduction) and the Solvency Capital Requirement (inclusive of any capital add-on imposed by the PRA). When applying to use the transitional deduction, a firm should calculate its Solvency II financial resources requirements as at the Solvency II implementation date of 1 January 2016.

3.14 This amount should be compared with the financial resources requirements that apply to the firm under the pre-Solvency II overall financial adequacy rule at 31 December 2015. For the avoidance of doubt, this must take into account any Individual Capital Guidance that the PRA has given to a firm.

3.15 If the Solvency II financial resources requirement would be lower than the pre-Solvency II financial resources requirement, the transitional deduction must be reduced until this is no longer the case. Note that this may result in a transitional deduction of zero. The transitional deduction cannot be negative.

### Limiting the amount of the transitional deduction in future years

3.16 At the end of each year from 2016 to 2031, firms that have received approval to use a transitional deduction should re-assess the extent to which it is necessary to limit the deduction and discuss this re-assessment with their normal supervisory contact.

(1) Note that these Directives are minimum harmonising. In some areas, transposition of their requirements into UK law has permissibly supplemented the legal minimum required by these Directives. The EU minimum amount of technical provisions may thus be different (and in particular may be lower) than the amounts calculated in accordance with the PRA's rules in INSPRU 1.

### Application at the level of homogeneous risk groups

3.17 Where firms wish to apply the transitional deduction at the level of selected homogeneous risk groups, they must be able to demonstrate that they can reliably calculate the technical provisions amounts at rules 11.2(2) or 11.3(2)(a) or (b), using the same homogeneous risk groups as are used for their Solvency II technical provisions. The firm must also be able to demonstrate that the amounts of technical provisions calculated at the level of the selected homogeneous risk groups are consistent with the technical provisions calculation for the entity as a whole.

## 4 The approval process

4.1 Firms wishing to use the transitional measures on the risk-free interest rate or on technical provisions may submit an application to the PRA electronically from 1 April 2015. For planning purposes, the PRA asks firms to notify their normal supervisory contact at the earliest opportunity if they intend to make an application.

4.2 For the approval process on the transitional measures, 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. Where an application has not been approved, the PRA will communicate the reason for the rejection.

4.3 If further information is required from the firm during the review, the PRA will request this information in writing.

4.4 When submitting an application for these transitional measures, firms should inform the PRA of any other approvals for which they have applied. The PRA encourages firms to also give details of any other approvals for which they intend to apply during the next twelve months.

4.5 As part of the application process the PRA may ask firms to obtain an external validation of the calculations they have performed. In such cases, the scope and timescales for the validation will be agreed with firms on a case-by-case basis.

## 5 Interaction with other Solvency II approvals and contingency planning

5.1 Firms submitting applications for multiple Solvency II approvals, including for the internal model, are expected to understand any dependencies between the 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.

5.2 Where firms apply for the transitional deduction at the same time as applying for the matching adjustment (MA), the PRA expects firms to provide sensitivity tests showing the impact on the transitional deduction if the MA application were to be rejected.



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Supervisory Statement | SS[xx]/15

# Solvency II: the internal model treatment of participations

January 2015

## 1 Introduction

1.1 This supervisory statement is of interest to all UK insurance firms within the scope of Solvency II and to the Society of Lloyd's. The PRA expects firms to read this statement alongside all relevant European legislation and relevant parts of the PRA Rulebook.

1.2 The PRA is publishing this statement to set out expectations of firms in relation to how participations in insurance and reinsurance undertakings are accounted for in the Solvency Capital Requirement (SCR) at solo level. The PRA regards the benefits of providing appropriate levels of policyholder protection from exposure to the risks associated with such participations as proportionate to compliance costs, which are not expected to increase compared to the current approach.

1.3 The statement sets out issues that the PRA expects firms to have considered when calibrating their internal models to ensure that they adequately address the risks posed by those participations.

1.4 This statement expands on the PRA's general approach as set out in its insurance approach document.<sup>(1)</sup> By clearly and consistently explaining its expectations of firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates, and contributing to securing an appropriate degree of protection for policyholders. 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.

1.5 The PRA is publishing this statement to set out expectations of firms in relation to how participations in insurance and reinsurance undertakings are treated when the SCR is determined at the solo level using an approved internal model. The PRA expects benefits from the maintenance of the levels of policyholder protection envisaged by Solvency II requirements, by clarifying its expectation that capital requirements should reflect the economic reality of exposure to the risks associated with such participations. Some firms may see their SCR increase compared to what they had been expecting if they were contemplating a different approach. The PRA does not regard these costs as incremental compared to Solvency II requirements (which are set out below). The PRA regards the benefits of this statement as proportionate to the costs. It also expects to facilitate effective competition by ensuring that firms are held to a common standard for policyholder protection.

1.6 The proposals in this draft supervisory statement would not have any direct or indirect discriminatory impact under existing UK law.

## 2 Risks posed by participations in insurance and reinsurance undertakings

2.1 Where a firm owns a participation in an insurance or reinsurance undertaking, this will appear as an investment on the firm's balance sheet. This will generally pose a risk to the firm as if the undertaking in which the participation is held suffers a loss, this will impact the participating firm's balance sheet. This risk should be reflected in the solo SCR for the participating firm.

2.2 When considering how to reflect this risk in an internal model, firms may consider it appropriate to examine the characteristics of the assets and liabilities of the undertaking in which the participation is held and the risks arising from these. Firms may also consider the extent to which the risks of the assets and liabilities of the participant might diversify with the assets and liabilities of the participation.

2.3 Firms should also consider the risks posed by any obstacles to covering losses with resources currently held in the form of a participation in related undertakings. These obstacles might arise from any barriers to moving resources between entities, taking into account the lack of diversification under extreme scenarios.

2.4 As well as requiring that internal models should take account of all material risks, the Solvency II Regulations require that the assumptions underlying the system used for measuring diversification effects should be justified on an empirical basis. Firms will therefore need to demonstrate that any allowance for inter-entity diversification in the calculation of the solo SCR appropriately takes account of restrictions on transferring resources between the participant and the participation.

2.5 Firms' attention is drawn to the draft European Insurance and Occupational Pensions Authority (EIOPA) Guidelines which state that the calculation of the solo SCR should not be replaced with a consolidated calculation as though the participating undertaking and its related undertaking were a Solvency II group.<sup>(2)</sup>

## 3 Group SCR calculation

3.1 For the avoidance of doubt, this supervisory statement does not relate to the calculation of the group SCR. The calculation of group own funds takes account of obstacles to transferring resources between entities,<sup>(3)</sup> meaning that these obstacles do not need to be reflected in the group SCR.

(1) [www.bankofengland.co.uk/publications/Documents/prapproach/insuranceappr1406.pdf](http://www.bankofengland.co.uk/publications/Documents/prapproach/insuranceappr1406.pdf).

(2) [https://eiopa.europa.eu/Publications/Consultations/EIOPA\\_EIOPA-BoS-14-181-Final\\_Report\\_Group\\_solv.pdf](https://eiopa.europa.eu/Publications/Consultations/EIOPA_EIOPA-BoS-14-181-Final_Report_Group_solv.pdf).

(3) Article 330 of the Directive.

3.2 This statement relates only to the calculation of the solo SCR. Since the determination of own funds at a solo level does not consider obstacles to transferring resources between entities, it is the PRA's view that any such obstacles should be reflected in the calculation of the solo SCR.