BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Solvency II: An update on implementation

Introduction

Solvency II will apply from 1 January 2016. Firms have made significant progress towards compliance with the new regime. The PRA will publish a consultation paper on transposing the Solvency II Directive into the PRA Rulebook in August 2014.

Some areas of regulatory uncertainty remain. The European Commission has not yet published its Delegated Acts for scrutiny. EIOPA is currently consulting on its Implementing Technical Standards and guidelines, which we expect to be adopted in stages up until July 2015.[1] Once adopted, these implementing measures will provide much greater policy certainty for firms.

This note provides further clarity wherever possible and appropriate to do so on the implementation of the new regime.

Availability of group own funds

The PRA is aware that firms are making a number of assumptions when preparing to assess the availability of group own funds. We would particularly like to draw attention to the following points, which may help firms in their preparations.

Availability assessment

The PRA expects the Solvency II Delegated Acts and Implementing Technical Standards (the Solvency II Regulations) to include an availability assessment that requires the PRA to consider two types of restrictions:

- the fungibility of the own fund items of related undertakings (ie whether they are dedicated to absorb only certain losses); and
- the transferability of the own fund items of related undertakings (ie whether there are significant obstacles to moving own fund items from one entity to another within the group).

Some groups appear to have only considered the legal restrictions when providing information to the PRA on the availability of own funds at the group level. However, the PRA expects groups to consider both legal and *regulatory* restrictions when considering any limitations on availability. The PRA expects this to be in line with the requirements to be set out in the Delegated Acts.

[1] Firms may find more information on EIOPA's consultations at:
https://eiopa.europa.eu/activities/insurance/solvency-ii/index.html

Standard of evidence

Groups can take a number of actions to transfer own funds around the group, for instance through paying dividends, or selling an undertaking. The PRA will consider these actions when reviewing a group's assessment of transferability. However, the PRA expects groups to provide robust evidence that the own funds available at the group level have no legal or regulatory restrictions on transferability and that the suggested action resulting in the transfer of the own funds does not jeopardise an orderly resolution of the group. In particular, the PRA expects the evidence to consider as a minimum the likely scenarios under which the actions could be taken, and the time it would likely take to execute the actions. For the own funds considered available at the group level, the PRA expects groups to evidence that these own funds can be made available to the group within a maximum of 9 months.

Availability of third-country own funds at the level of the group

Under Solvency II, the PRA may decide to apply to a group the deduction and aggregation method (method two) calculation of its solvency requirements, which would allow a firm to use local solvency rules when determining the requirements placed on (equivalent) third-country related undertakings. However, the assessment of the availability at a *group* level of an own funds item of such a related undertaking needs to have regard to Solvency II standards.

To illustrate this point further, the assessment of availability will need to demonstrate that both the solo undertaking third-country rules and the Solvency II group rules have been considered. For example, this might mean that for an own funds item to be considered available at the level of the group, the firm should be able to defer coupon payments both in the event of non-compliance with the solo undertaking's third-country capital requirement and the Solvency II group solvency capital requirement (SCR).

Own funds of non-insurance undertakings

Firms should note that, when determining own funds at the level of the group, the Solvency II Regulations are expected to specify that own funds of non-insurance undertakings will also be subject to the availability assessment. For the purpose of the group solvency calculation, insurance holding companies, mixed financial holding companies, and subsidiary ancillary services companies are treated like insurance undertakings. Therefore, groups are expected to perform an availability assessment for own funds for these firms. Firms should also note that the draft EIOPA group solvency guidelines, currently out for public consultation,[2] provide further clarification, including that insurance special purpose vehicles within the scope of the group solvency calculation should also be subject to the availability assessment.

Operation of limits at a group level

The PRA is aware that firms are making a number of assumptions while preparing for compliance with Solvency II requirements on capital tiering limits. To aid preparations, we would like to draw attention to the following considerations in particular.

[2] See footnote 1.

In respect of groups, limits are applied only at the end of the process for determining group eligible own funds; the limits do not apply at interim stages in the calculation. A single group SCR is calculated having regard to the calculation method being used and the nature of the underlying entities. Group own funds are determined based on the relevant calculation method on the same basis – this is done before application of the limits. The resulting total then needs to be assessed to arrive at available group own funds. The considerations set out above under *Availability of group own funds* form part of this stage. As part of this process, firms need to comply with the Solvency II Regulations on the classification of own funds at group level for externally issued items and make an assessment of availability at group level in respect of the amounts recognised in the group reconciliation reserve. It is at this point that the limits apply with reference to the group SCR to provide group eligible own funds.

Firms should also note that the minimum consolidated group SCR is used as a proxy at group level where the relevant solo articles refer to minimum capital requirement (MCR). The minimum consolidated group SCR arises only in the case of calculations under method 1, whether used on its own or in a combination of methods 1 and 2.

Deferred tax

Deferred tax assets (DTA) and loss absorbing capacity of deferred tax (LAC of DT) may potentially have a significant effect on the calculation of own funds and capital requirements under Solvency II. Firms should read Supervisory Statement 2/14 'Solvency II: recognition of deferred tax' to understand the PRA's expectations.[3]

The matching adjustment

The PRA anticipates publishing a supervisory statement on the matching adjustment (MA) in Q4 2014. Many firms are currently participating in the trial MA Implementing Technical Standards (ITS) submission, which is helping to inform implementation.

In the meantime, to aid firms' preparations, further detail is provided below in addition to the PRA's earlier communication on asset eligibility.[4] This addresses a number of common questions that have been raised.

Many questions cannot be answered at this time due to the continuing development of European policy, where the PRA is awaiting policy to be developed by the European Commission and EIOPA.

Consistent with the PRA's judgement-based approach to supervision, the MA articles set out the criteria a firm must meet in order for its application to be approved. The onus is on firms to consider how to comply with the Directive requirements and how to demonstrate compliance to their supervisors.

[3] http://www.bankofengland.co.uk/pra/Documents/solvency2/matchingadjustmenttrialsubmission13june2014.pdf
[4] http://www.bankofengland.co.uk/pra/Documents/solvency2/matchingadjustmentasseteligibilityjune2014.pdf

Mismatching

The Solvency II Directive requires that any mismatch in the replication of expected cash flows does not give rise to material risks. The PRA will use the results of the trial MA ITS submission to understand how materiality is assessed by firms, and whether the assessment is consistent with the terms of the Directive. However, given the requirement under the Directive that firms submit a liquidity plan, it is likely that an assessment of mismatching materiality that only references the SCR will not be sufficient.

The PRA understands that some firms may wish to maintain a small surplus of expected asset cash flows over expected liability cash flows within the MA portfolio, for the purposes of efficient and prudent portfolio management.

Diversification benefit

The standard formula treatment of diversification benefit in relation to the MA is expected to be detailed in the Solvency II Regulations when they are adopted by the European Commission.

For the internal model treatment, no particular method is prescribed. Firms should have regard to best practices, such as making sure that diversification benefit is rigorously justified, and that availability of own funds, which is a pre-requisite for diversification benefit, is robustly assessed. The treatment of diversification benefit in relation to the MA must meet the tests and standards prescribed in the Directive, which are expected to be detailed further in the Solvency II Regulations.

Asset eligibility

As previously communicated[5], the PRA will not prescribe a closed list of eligible assets for the MA. Firms are responsible for assessing their own compliance with the requirements of the Directive and how they intend to demonstrate compliance to their supervisors, which will be assessed on a case-by-case basis.

Firms should note that the use of cash items is an acceptable feature of MA portfolios, since this is a practical solution to facilitate efficient portfolio management, including risk management.

Firms should also note that assets with optionality are not excluded from the scope of the MA, provided the risk of not being able to replace the cash flows if the option is exercised is negligible. This would permit standard Spens clauses and may permit modified Spens clauses (provided that the modification can be shown to replace the cash flows), 'extension in the event of default' clauses (although it is important to consider whether the definition of default in these clauses is captured within the fundamental spread) and standard redemption clauses.

Regarding the eligibility of different types of callable bonds, the PRA will assess submissions on a case-by-case basis in an approval process that will be detailed in the forthcoming supervisory statement referred to above.

[5] See footnote 4.

In all considerations about asset eligibility for the MA, a key question for firms to consider is whether they are exposed to the risk of changing spreads on the underlying asset, contrary to the fundamental rationale for the MA.

Pension schemes

Many firms are currently considering how to ensure compliance with Solvency II requirements on the treatment of pension risk.

Some firms are proposing to use International Accounting Standard Nineteen (IAS 19) as the basis for the recognition of amounts relating to employee pension schemes. Although the text is not yet stable, the Solvency II Regulations are expected to be consistent with this treatment. If this remains the case, then when a pension scheme is in deficit, that deficit would be recognised as a liability on the firm's balance sheet. If the scheme is in surplus, a firm can only recognise a balance sheet asset if the circumstances meet the requirements of IAS 19 in this regard.

In addition, firms must ensure that they recognise capital requirements relating to risks arising from employee pension schemes. Firms should have regard to the proposed EIOPA guidelines currently out for consultation[6], which describe how a firm should allow for pension scheme risks when using the standard formula to calculate its SCR.

Where a firm intends to use an internal model to calculate its SCR, Solvency II requires that the internal model must cover all of the material risks to which the (re)insurance and undertaking is exposed.

Solvency II deals with capital that must be held by an insurance or reinsurance firm to protect insurance policyholders against the risk posed by an occupational pension scheme associated with the firm, and also deals with capital that must be held by any group of which a firm is a member. Solvency II does not determine capital requirements for the pension scheme itself. These are not within the statutory remit of the PRA, but are regulated by the Pensions Regulator.

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[6] See footnote 1.