BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Director Life/General Insurance
Prudential Regulation Authority

14 July 2015

Solvency II Directors' update

We have recently passed two key Solvency II milestones. The first, 30 June, was the final day for applications for IM and other approvals for use on 1 January 2016. The second, 1 July for solos or 15 July for groups, were the deadlines for the submission of the preparatory phase regulatory reporting returns. From a PRA perspective, both appear to have gone smoothly.

For firms in the internal model process, supervisors have already written to firms to explain that firm specific panels will be held to assess individual applications. Where possible, these will contain the same members as the commitment panels held during the pre-application phase. Following this, an oversight panel will take place to ensure consistency and fairness between all firm specific decisions. The PRA intends to communicate the decision to each firm simultaneously, probably in early December 2015. The PRA will notify firms of precise timings closer to the time.

Solvency II – Set 2 of Solvency II draft Implementing Technical Standards and Guidelines

On 6 July 2015, EIOPA published the second set of draft Implementing Technical Standards (ITS) and Guidelines for Solvency II. The second set of ITS has been submitted to the European Commission (EC) for scrutiny and endorsement. It is expected that both the ITS and Guidelines will be applied from 1 January 2016.

Output of GI technical workshop

The PRA has held a Solvency II workshop with a number of representatives from the Association of British Insurers (ABI). This was a useful discussion of key areas where the general insurance industry is seeking clarity. The key points were:

- **Moving from ICA to the Solvency II regimes**. The PRA has recently published a supervisory statement SS26/15: Solvency II and the ultimate time horizon, which set out the expectation that risks should be considered over the ultimate time horizon in a firm's ORSA, but also noted that there was no requirement under Solvency II for firms to hold capital to a level commensurate with this.

- **PPO modelling.** The PRA noted that PPOs were an important feature of the general insurance industry and confirmed its concern that the standard formula will not adequately capture the risk for firms with material PPO exposures. The PRA highlighted the need for firms to make appropriate allowance within the risk margin for these exposures and to be able to demonstrate how they have approached this.

- **Catastrophe Modelling.** The PRA reminded firms they need to assess whether the standard formula results are appropriate for their catastrophe exposures and noted that the results of the catastrophe modelling carried out by firms to inform their reinsurance purchasing could be a valuable guide in forming this view.

- **PRA information requests post Solvency II.** The PRA acknowledged industry concerns about the volume and content of information requests from the PRA post Solvency II. The PRA has now published SS25/15: regulatory reporting, internal model outputs, which provides more detail about information requests under Solvency II.

- **Volatility Adjustment.** As the PRA noted in its supervisory statement on the volatility adjustment (SS23/15: supervisory approval for the volatility adjustment), the PRA will operate a proportionate approval process. Firms should bear this in mind when considering what level of detail to submit in their application. When considering applications, the PRA will have regard to the risks that an individual firm poses to its objectives, as well as the impact of the volatility adjustment on the firm's balance sheet.

Segmentation of UK Motor Insurance Policies

Data the PRA has received from firms has demonstrated that motor insurance business is not being unbundled in accordance with Solvency II Delegated Regulation Article 55(6).

In the UK a comprehensive motor insurance policy provides property damage cover for an insured's own vehicle along with third party liability cover. Third party liability cover would indemnify the insured against claims from third parties in respect of both bodily injury and property damage. The PRA would expect these policies and claims to be unbundled into the appropriate Solvency II lines of business. This impacts both reporting and also standard formula calculations.

Specifically, third party liability claims, both property and bodily injury, should be allocated to line of business 4 "Motor Vehicle Liability" or 26 "Non-proportional Casualty" and own property damage should be allocated to line of business 5 "Other Motor" or 28 "Non-proportional property". Where only one of the risks is considered material, the technical provisions guidelines[1] state that the unbundling of the obligations is not required. Where the risks within "Other Motor" cannot be shown to be immaterial, and to ensure that motor business is treated consistently, firms should be unbundling their motor business into the appropriate Solvency II lines of business.

In respect of general insurance claims which are settled as an annuity, such as PPOs, the PRA is aware that there are different approaches being taken in the market regarding allocation to Solvency II line of business. The PRA would like to draw firms' attention to the log file for S_16_01 which sets out how annuities stemming from non-life contracts should be reported.

Recognition of outwards reinsurance

The PRA is aware that firms have made a number of different interpretations of the Solvency II requirements around the recognition of outwards reinsurance. When considering outwards reinsurance cash-flows, the key principles are:

- for inwards business, all future receipt and payment cash-flows within a contract boundary are included in technical provisions;

- for outwards business, obligations to make future payments that fall within a contract boundary, calculated consistently with the cash-flows recognised for the inwards business, are included in the balance sheet. Only future receipts that relate to cash-flows of existing inwards business are included in recoverables from reinsurance contracts.

Therefore, any future premiums payable under bound outwards contracts (e.g. future instalments of minimum and deposit premiums, or other outwards premium) should be included on the balance sheet. These premium payments should be recognised at the level to which they are contractually obliged based on existing inwards bound business, with no consideration to the future (unbound at the valuation date) inwards business. Where an existing reinsurance contract provides recoveries from inwards contracts that are not bound at the valuation date (e.g. RAD cover already purchased for the forthcoming year or existing LOD covers), only the reinsurance recoverable cash-flows that relate to existing inwards contracts should be included. This is to ensure consistency with the inwards contracts valuation.

[1] EIOPA-BoS-14/166 Guideline 21

When considering how future reinsurance purchases should be recognised, firms should follow Guideline 78 in EIOPA-BoS-14/166.

Allocation of Employers Liability Insurance Policies

Delegated Regulation Article 55(3) sets out that "the assignment of an insurance or reinsurance obligation to a line of business shall reflect the nature of the risks relating to the obligation. The legal form of the obligation shall not necessarily be determinative of the nature of the risk". The standardised risk and comparison data the PRA has received from firms has demonstrated that some employer's liability contracts have been assigned to Line of Business 3, Workers Compensation, when they would more naturally have been assigned to Line of Business 5, General Liability. Firms should take care to ensure they have assigned their employer's liability policies to the correct line of business and should be able to explain and justify the allocation decisions they make.

Pension scheme risk

On 20 March 2015, the PRA issued supervisory statement SS5/15: Solvency II: the treatment of pension scheme risk. The statement set out the PRA's expectations of firms in relation to the treatment of defined benefit pension schemes under Solvency II.

The PRA has now reviewed the treatment of pension scheme risk for a number of Solvency II internal models and in some firms the treatment in relation to credit spread risk has fallen short of our expectations. SS5/15 states that the PRA expects firms to "justify any allowance made in an internal model for pension scheme liabilities to change following a shock to credit spreads".

In modelling the IAS19 discount rate, some firms have assumed that the full movement in high quality corporate bond credit spreads is passed on to the discount rate. Some other firms have removed the impact of defaults and downgrades from the movement in credit spreads to ensure that the resultant yield is reflective of the yield on high quality corporate bonds. The PRA considers that such approaches do not adequately capture the risks that firms are exposed to. In particular, there is a risk that under stressed conditions:

- the market in some high quality corporate bonds may not be considered "deep" and therefore using the yield on these bonds may not satisfy the requirements of IAS19, even if an adjustment is made to ensure that they remain high quality.

- there is a significant divergence between the IAS19 deficit and the scheme funding deficit, increasing the likelihood that the firm is required to pay additional contributions to the pension scheme.

The PRA expects firms to reflect these risks within their internal models and consider that an approximate approach of assuming that only part of the movement in credit spreads is passed on to the IAS19 discount rate may be acceptable in appropriate circumstances.

SIMR

On 7 July 2015, the PRA published policy that completes the framework for individual accountability in the banking sector. The material in PS16/15, SS28/15 and the Statement of Policy addresses the Senior Managers Regime and only relates to the banking industry.

In March, the PRA published one Policy Statement (PS 3/15) covering the SIMR, and policy on the Senior Insurance Managers Regime with equivalent material is expected to be issued soon (following our public consultations in Feb/March in CPs 7/15, 12/15, and 13/15).

Our new Senior Insurance Managers Regime (SIMR) is intended to:

- ensure that all insurance firms and groups have a clear (and effective) governance structure; and
- clarify and enhance the accountability and responsibility of individual senior managers and directors.

As such, it will include a number of new and enhanced features and in particular a Solvency II related requirement on firms to produce by 1 January 16, and then maintain, a governance map which will:

- identify all their 'key functions' [see PS 3/15];
- identify who is responsible for those functions;
- set out the responsibilities for each key function holder; and
- set out the lines of accountability and responsibility for each key function holder within the firm and any wider group

Ahead of implementation, all firms should therefore carry out the following steps:

- familiarise themselves with the requirements of the new SIMR, including our new 'Prescribed Responsibilities';
- prepare a governance map (with the features outlined above);
- identify which existing Controlled Function (CF) roles will 'grandfather' into the SIMR.(for grandfathering to apply, the individual must be performing the same function both at date of notification and on 7 March 2016); and
- consider whether there are other individuals who are not currently approved as CFs but will be performing a SIMF under the SIMR, or who will be deemed to be a key function holder.

Solvency II and Groups

Firms should note that there are some significant differences with the requirements for group supervision regime under Solvency II. Changes include:

- how a group is identified;
- the type of group; and
- the nature and extent of group supervision.

Much of the Solvency II Directive applies to groups on a 'mutatis mutandis' basis. Whatever is required in respect of an individual insurance firm may also be required for groups. There are, however, also requirements which are specific to groups. It is, therefore, essential that insurers know if they are part of an insurance group of a financial conglomerate, what the group requirements mean for them, and to be prepared to meet those requirements.

If firms have not already done so, they should establish as a matter of urgency:

- whether they are part of a group, or groups, that will fall within the scope of the Solvency II requirements;
- if they are part of a group, what type of group(s) will they be a part of e.g. a group headed by an insurance holding company or a mixed activity insurance holding company;
- what they will need to do to meet all the relevant groups requirements of Solvency II; and
- what approvals and/or waivers they might require to assist them in complying with the groups requirements of Solvency II.

See: http://www.bankofengland.co.uk/pra/Pages/solvency2/groups.aspx

Yours sincerely

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Timetable of activity Jul 2015 to 2015 Q2

Date	Description
July	Supervisory Statement: Treatment of sovereign risk in the IM
August	Supervisory Statement: Consistency of UK generally accepted accounting principles with Solvency II Directive
August	Supervisory Statement: Internal model codes and components and life product codes
August	Consultation Paper: Set 2 Solvency II technical standards and guidelines
August	Consultation Paper: Solvency II ITS regular quantitative reporting – PRA discretion
September	Letter: PRA feedback on reporting submissions from in-scope firms for EIOPA's preparatory guidelines
September	Letter: Information for smaller firms due to submit Solvency II reporting for the first time in 2016

25 November 2016: This letter has been archived. Appendix 8 of Policy Statement 33/16 lists the supervisory statements in which the PRA's expectations, where relevant, are available.
See http://www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps3316.aspx

Solvency II web updates since the last Directors' update

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

On 7 July 2015, the PRA published policy that completes the framework for individual accountability in the banking sector. The material in PS16/15, SS28/15 and the Statement of Policy addresses the Senior Managers Regime and **only relates to the banking industry**. Policy on the Senior Insurance Managers Regime with equivalent material is scheduled for release in due course, and will be made available in the usual way.

June 2015

On 15 June 2015, the PRA published the following:

- A supervisory statement setting out its expectations of life and non-life firms and providing further clarity on the information to be reported by firms using an internal model to calculate the solvency capital requirement (SCR);

SS25/15: Solvency II: regulatory reporting, internal model outputs

- A supervisory statement setting out its expectations of how non-life firms should identify and manage all risks to which their business could be exposed over the long and short term;

SS26/15: Solvency II: ORSA and the ultimate time horizon – non-life firms

- A letter from Sam Woods, Executive Director of Insurance Supervision, providing firms with feedback on the PRA's review of firms' own risk and solvency assessments (ORSAs) submitted in 2014 and 2015 [during the preparatory phase]; and

Solvency II: ORSA feedback, 15 June 2015

- Information regarding Legal Entity Identifiers on its 'Detailed technical information' page.

Detailed technical information

On 12 June 2015, the PRA published feedback on step 1 of its review of Solvency II balance sheets. This follows two related publications dated October 2014 and February 2015, which can be found on the 'Other Pillar 1 aspects' page.

PRA Solvency II: Balance sheet feedback, June 2015

Other Pillar 1 aspects

On 8 June 2015, the Bank of England published a pre-release article of the Quarterly Bulletin 2015 Q2 titled 'The prudential regulation of insurers under Solvency II'. A news release and short video discussing some of the topics covered in the article is also available.

The prudential regulation of insurers under Solvency II

Quarterly Bulletin 2015 Q2 pre-release article, news release and video

On 5 June 2015, the PRA provided clarification for firms on volatility adjustment in the modelling of market and credit risk stresses. More information can be found on the Solvency II internal model page.

Solvency II internal models

On 1 June 2015, the PRA published the following:

- A consultation paper that includes two draft supervisory statements. The first is on internal model reporting codes and components, and 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. The second, on life product 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.

25 November 2016: This letter has been archived. Appendix 8 of Policy Statement 33/16 lists the supervisory statements in which the PRA's expectations, where relevant, are available.
See http://www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps3316.aspx

CP20/15: Solvency II: internal model reporting codes and components and life product codes

- A supervisory statement setting out its expectations of firms applying for permission to apply a volatility adjustment (VA).

SS23/15: Solvency II: supervisory approval for the volatility adjustment

- A letter from Sam Woods, Executive Director of Insurance Supervision, on the matching adjustment. This letter provides further clarification around three specific areas of feedback given in Paul Fisher's letter of 28 March 2015; i) management of collateral arrangements; ii) collateral received against stock-lending activity and iii) the treatment of reinsurance in the MA calculation. It also provides additional points of feedback on issues that have emerged following the pre-application phase. It should be read alongside earlier industry feedback letters available in Key Resources on the Solvency II approvals page.

Solvency II: matching adjustment update, 1 June 2015

Solvency II approvals

May 2015

On 29 May 2015, the PRA updated its instructions on the use of the Solvency II taxonomy in the preparatory phase. The Bank of England also published a Solvency II XBRL filing manual available on the 'Taxonomy' page in Key Resources via the link below.

Taxonomy