



**BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY**

Director Life/General Insurance  
Prudential Regulation Authority

13 March 2015

### **Solvency II Directors' update**

The PRA has issued a number of communications on Solvency II related issues over the last month to ensure that firms continue to be informed of our latest thinking. Two recent Executive Director letters update firms on the matching adjustment (MA) and the internal model. The first [letter](#) clarifies the PRA's expectations of firms planning to re-structure their equity release mortgage portfolios in order to meet the MA eligibility criteria. The [second](#) provides clarity on how internal models allow for MA portfolios; information on the quantitative framework that the PRA will use as part of its review of internal model applications; and initial feedback from the MA pre-application process. The information in each of these letters should help firms submit robust formal applications for both the internal model and the matching adjustment.

### **PRA planning for approvals applications process**

Some firms have questioned whether the PRA will be able to handle the large number of approval submissions that are expected from 1 April 2015 in the run up to implementation. The PRA is currently updating its timetable with detail of when firms expect to submit Solvency II approval applications. To ensure this updated timetable is accurate, supervisors will be liaising with firm contacts during the next two weeks to ensure that the PRA's information is correct.

It is essential that firms submit high quality applications which meet all the requirements of Solvency II and take into account PRA guidance and feedback. This will enable the PRA to review applications and respond to firms with a decision within the prescribed timescale.

### **Briefing for non-executive directors (NEDs) of internal model firms**

The PRA will be holding a briefing seminar for NEDs of internal model firms on 19 March 2015. The slides will be made available on the Solvency II updates page of the Bank of England website.

In addition, Paul Fisher will be participating in a webcast hosted by the ABI where he will talk about the PRA's policy statement 'Transposition of Solvency II' into the PRA Rulebook and the role of NEDs, specifically with regard to smaller firms. The webcast will be available on the ABI and PRA websites at the end of March.

### **EIOPA update on relevant risk-free interest rate term structures**

On Saturday 28 February 2015, EIOPA [published](#) the first set of risk-free curves and other related technical information for Solvency II. The published package includes the basic risk-free curves, the curves inclusive of a volatility adjustment, and the fundamental spreads for use in the calculation of the matching adjustment, as

at 31 December 2014. The corresponding technical information as at 31 January 2015 and 28 February 2015 was added on Friday 6 March 2015, and from now on the data will be published on a monthly basis. EIOPA has also published Technical Documentation explaining the methodologies and assumptions that are used to derive all of the published technical information. Firms should now refer to and use the latest available version of EIOPA's technical information in their preparations for Solvency II. Any questions should be directed to the firm's usual supervisory contact.

### **Feedback on tax effects on the solvency capital requirement**

On 20 February 2015 the PRA updated [supervisory statement SS 2/14 Solvency II: recognition of deferred tax](#), to expand on the PRA's rationale for its expectations in a variety of areas, including the IAS12 'more likely than not' recognition test (recognition test), and the projection methodology that it expected firms to adopt. The expectations set out in the supervisory statement apply equally to firms using the standard formula or an internal model to calculate their solvency capital requirement (SCR) except in regard to the ability to apply group relief, where the expectations are different depending on the means of calculation.

The PRA has now reviewed a number of initial proposals from firms to support calculation of the tax effects of the 1 in 200 shock ('tax effects') when calculating their SCR. Where the calculation relates to components of an SCR which are not calculated using the standard formula, the calculation of the tax effect is part of an internal model. Firms will need to comply with guidelines concerning internal models; the PRA emphasises that the feedback on internal models given in the appendix to the [PRA Directors' update of 12 February](#) is relevant to all aspects of the calculation of the tax effects in an internal model.

As for the recognition test itself, the PRA has found that firms' documentation of their assessment of the extent to which resources would need to be replenished, and the sources of that replenishment (whether through building up reserves over time from trading profits or by issuance of new capital instruments), has been poor. To meet the recognition test the PRA expects that the resources needed to support a level of trading in the post-shock environment would be consistent with a firm's own risk and solvency assessment in that environment. Further, the documentation regarding availability and timing of capital replenishment in the post-shock environment has not always been of a standard to give the PRA the confidence it requires to accept the expert judgements made by a firm.

The PRA expects the same standard of documentation to support tax effects, whether calculated using an internal model, or applied to standard formula SCR components. The PRA has identified that the tax effects recognised in an internal model SCR are often based on assumptions, judgements and documentation specific to the particular SCR scenario and are not shown to be valid across the probability distribution forecast. Such an approach does not demonstrate that the tax effects across the probability distribution forecast generated by the internal model meet calibration standards, and there is potential for the incorrect pre-tax effects scenario to be selected as the biting scenario. It would be difficult for the PRA to conclude that such an internal model meets the statistical quality standards required by Solvency II.

Some firms are assuming that certain asset classes will earn above the risk-free rate of return after the SCR stress as a result of an assumed market recovery ('mean reversion') after the stress event or the emergence of risk premiums on certain asset classes post stress. Given the inherent complexity and significant expert judgements required in modelling such items post stress, the PRA is of the view that it will be very difficult for firms' methodologies to support the recognition of the deferred tax asset by identifying this excess income as a likely source of future taxable profit.

## **Internal models**

### ***Validation in the internal model***

During its internal model review work, the PRA continues to observe that validation materials provided by firms are primarily focussed on the bottom-up justification of parameters and assumptions and may not be clearly aligned to enable senior management and Boards to challenge effectively the key assumptions and limitations of the model.

Although a bottom-up approach is an important aspect of the internal model validation, the PRA emphasises that Boards should value the role that good validation can play in helping them to understand the key drivers and limitations of a model. On application, the PRA's expectation is that firms will provide evidence that the Board has challenged: the validation process and its results; understood and satisfied itself on the key assumptions and limitations of the model; considered the possible quantification of these limitations; and taken appropriate mitigating actions. The PRA would expect Boards to be tracking actively progress in addressing key issues identified by validation work.

More information is available on the [Solvency II internal model page](#) of the Bank of England's website.

### ***Modelling of premium provision at t=1 for general insurance firms***

The PRA recommend that general insurance firms should consider variability in premium provisions on their year-end Solvency II balance sheet. In the same way that events can occur that cause claims provisions to vary, some of those same events will also cause premium provision to vary. Examples include changes in court awards for liability claims or a natural catastrophe event that was previously thought to be impossible, like the Tohoku earthquake.

Firms that do not consider this risk may fall short of the internal model tests and standards. The PRA considers this risk exists for all actively underwriting internal model firms who model on a one-year earned basis, albeit it may be that for some firms this risk will be small in the context of the total solvency capital requirement.

## **Regulatory reporting**

### ***EIOPA update on Solvency II Preparatory Taxonomy***

EIOPA has released the final corrective version of the [Solvency II Preparatory Taxonomy \(v1.5.2.C\)](#) for regulatory reporting templates. The Bank of England will be using this version of the taxonomy in its data collection system. This version improves the 'validation rule error messages' from the previous versions and includes a fix for solvency capital requirement reporting at ring fenced fund level when using an internal model. Members of the PRA's regulatory reporting industry working group and testing sub-group have been made aware of the change.

More information on the version firms are expected to use, and links to useful information, can be found on the [Solvency II regulatory reporting page](#) of the Bank of England's website.

## **Onboarding**

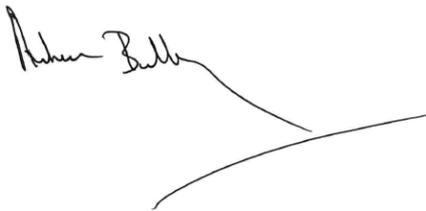
In early April the Bank of England will be contacting the nominated principal users of each firm due to submit under EIOPA's Preparatory Guidelines with details of the Bank of England's data collection system and information on the onboarding processes. As part of this, firms will be able to schedule a one-to-one onboarding session with the Bank of England, and the principal user will be given their log in details ahead of this session.

## 2015 general insurance stress test

As highlighted in the [Directors' Update on 21 November 2014](#), the PRA intends to send a questionnaire to general insurance firms asking for information on stress testing. This work will support the PRA's ongoing monitoring of how insurers are developing the ORSA, as well as providing an overview of the UK industry's reliance on specific counterparties and jurisdictions under stressed conditions. The questionnaire will be similar to the stress test exercise carried out in 2011 for internal model firms, except that the PRA intends to broaden the scope to include most general insurers. As in 2011, the PRA will ask firms to provide the impact of specific stress tests both before and after mitigation.

The PRA intends to send the final questionnaire with details of stresses, the template and instructions to firms during 2015 Q3. During April 2015, as the questionnaire is developed the PRA will seek feedback from a small number of firms. If your firm is interested in participating in this exercise, please inform your normal supervisory contact or [Stefan Claus](#).

Yours sincerely



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Director, Life Insurance



Chris Moulder  
Director, General Insurance

## Timetable of activity March 2015 to 2015 Q2

Date	Description	Information or Action
19 March	Responses to consultation paper <a href="#">CP5/15: Solvency II: applying EIOPA's set 1 Guidelines to PRA-authorized firms</a>	Action
19 March 2015	Briefing for non-executive directors (firms likely to use an IM)	Information and action
28 March 2015	Individual firm feedback following MA submissions	Information
March 2015	Consultation paper on volatility adjustment (depending on HMT decision)	Action
April 2015	Feedback on the MA pre-application process	Information and action
March 2015	Policy Statement: Transposition of Solvency II into the PRA Rulebook	Action
March 2015	Communication on sovereign debt	Information and action
1 April	Solvency II Transposition	Action
April 2015	Consultation paper on consistency of UK GAAP with Solvency II Directive	Action
April 2015	Feedback on the preparatory guidelines – ORSA and system of governance	Information and action
April 2015	Feedback on the internal model pre-application process	Information and action
April 2015	Communication on regulatory reporting 'on-boarding'	Action
May 2015	Regulatory reporting working group	Information and action
1 May 2015	<a href="#">Data collection exercise for general insurance firms</a> – responses due	Information and action
1 July 2015	<a href="#">Data collection exercise for life firms</a> – responses due	Information and action
2015 Q2	PRA to provide information on GI stress testing questionnaire	Information and action
2015 Q2	Communication on standard formula appropriateness and interventions	Information and action

## **Solvency II web updates since the last Directors' update**

### **March 2015**

On 9 March 2015, the PRA published a letter from Paul Fisher, Executive Director of Insurance Supervision. The letter: clarifies how internal models allow for matching adjustment portfolios; provides information on the quantitative framework that the PRA will use as part of its review of internal model applications; and gives initial feedback from the matching adjustment pre-application process.

 **Solvency II: internal model and matching adjustment update, 9 March 2015**

### **February 2015**

On 27 February 2015, the PRA issued data collection exercises to both life and general insurers. This followed the information in the Insurance Directors' letter of 12 February 2015. A summary of the data requests, including response dates, is available below.

 **Summary of PRA Solvency II data collection exercises, 27 February 2015**

On 20 February 2015, the PRA published an amendment to supervisory statement SS2/14 -Solvency II: recognition of deferred tax. This is relevant to all insurance firms within the scope of the Solvency II Directive.

 **Solvency II: recognition of deferred tax – SS2/14 UPDATE**

Also on 20 February 2015, the PRA published a letter from Paul Fisher, Executive Director of Insurance Supervision. The letter clarifies the PRA's expectations of firms planning to re-structure their equity release mortgage portfolios in order to meet the matching adjustment eligibility criteria.

 **Letter from Paul Fisher - Solvency II: equity release mortgages**

On 19 February 2015, the PRA published a consultation paper that sets out the PRA's expectations of firms in relation to the European Insurance and Occupational Pension Authority's (EIOPA's) Set 1 Solvency II Guidelines which were published on 2 February 2015.

 **CP5/15 - Solvency II: applying EIOPA's Set 1 Guidelines to PRA-authorized firms**