BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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Solvency II Directors' update

As we enter the final two months before the implementation of Solvency II, the PRA's priority is to review applications for Solvency II approvals. We direct firms to the letter from Sam Woods, Executive Director of Insurance Supervision, dated 24 September. The letter provides firms with information on Solvency II-related approvals; applications to use the matching adjustment; applications to use an internal model; capital add-ons; and feedback on the preparatory phase data submissions received in July 2015.

Equity release mortgages

As the PRA reviews trends over the past year, we note some firms are increasing their investments in alternative assets. These assets may provide benefits (eg higher yields) but also give rise to other issues, such as valuation uncertainty, reduction in or absence of market price signals, and limited ability to trade. In this context, where these assets are generally marked-to-model, Solvency II introduces requirements which are much more specific than the United Kingdom's previous risk-based solvency regime (ICAS).

One such asset class is equity release mortgages (ERMs), where valuations need to address particular challenges. These include how to update valuations over time and in response to new information, or how to value embedded options and guarantees when assessing the appropriate value for the asset and the appropriate capital treatment. These considerations are relevant to mark-to-model assets generally, not only ERMs.

As part of the supervisory review process, we intend to undertake an industry-wide review during 2016 of ERM valuations and capital treatment. The outcome of that review may lead to a re-assessment of the extent to which firms are complying with the Solvency II requirements in areas such as asset valuation and the prudent person principle. Where the review results in a changed assessment of firms' risk profiles it may also lead, where applicable, to a reassessment of firms' continued compliance with Solvency II requirements. This might cover internal models, the requirements for assumptions underlying the solvency capital requirement (SCR, whether calculated under an internal model or the standard formula) or the criteria for matching adjustment eligibility.

25 November 2016: This letter has been archived.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

Risk margin methodologies

The appropriateness of firms' risk margin methodologies was investigated as part of the balance sheet review (BSR) by external auditors. Reports from Step 1 of the BSR revealed that the range of methodologies and approximations used by firms in projecting the future non-hedgeable SCR, varied widely. The main findings are in Annex 1 to this letter.

Calculation of the transitional deduction for technical provisions (TDTP)

The PRA expects that the calculation of the TDTP and the resulting quantum of the deduction will be overseen by the audit committee of the firm. The Chair of the audit committee will be asked to provide written confirmation to the PRA that the numbers are suitable for use and meet the requirements of the written notice. This should be done for the opening Solvency II balance sheet and repeated on an annual basis, and also after any recalculation is performed.

Reinsurance counterparty credit risk

The Solvency II regime promotes wider interests for the insurance sector such as competition, the freedom of movement of capital and the removal of restrictive practices. Solvency II also requires management of risk in a prudent fashion. The PRA appreciates that, to some extent, these aspects can potentially be in conflict, for example, when firms have significant concentrations of reinsurance counterparty default risk.

Many UK-regulated insurance firms make extensive use of risk transfer through reinsurance often intragroup reinsurance. Where a firm reinsures to a single or only a few counterparties (or connected counterparties), that firm can be exposed to a significant concentration of counterparty default risk. The PRA continues to expect firms to manage and mitigate reinsurance counterparty default risk under Solvency II. Rule 3.1(2)(c)(iv) of the PRA Rulebook: Solvency II Firms – Conditions Governing Business requires firms to have a risk management system covering 'concentration risk management'. This includes all risk exposures with a loss potential which is large enough to threaten the firm's solvency or financial position. Rule 3.1(2) makes clear that the risk management system should cover risks which are covered by the SCR as well as those which are not, or not fully, included in the calculation of the SCR. Accordingly, it may not be sufficient to refer to SCR components covering counterparty default risk and risk concentrations; additional measures besides capital may be required.

While recognising that Solvency II promotes the removal of restrictive practices, for example by prohibiting requirements concerning the localisation and pledging of assets in relation to certain reinsurance cessions (Articles 134 and 173 of the Solvency II Directive (2009/138/EC)), the PRA will continue to require firms to mitigate reinsurance counterparty default risk concentrations by demonstrating prudent risk management and compliance with other requirements of our rules. This mitigation may take various forms, and will often be uniquely tailored to the firm's specific business. Overall, the PRA's expectation of firms' appetites for this risk, and their identification, reporting and mitigation of major reinsurance counterparty default risk under the Solvency II Directive, has not changed. Firms are expected, among other actions, to continue monitoring the level of annual cessions as a proportion of their gross premiums and the quantity of reinsurance recoverables compared to their available capital resources, and take appropriate actions to manage risks arising. Additionally, firms need to take into consideration aspects relating to the prudent person principles (PRA Rulebook: Solvency II Firms – Investments) as well as to what extent the reinsurance concentrations may impede effective resolution (as required by Fundamental Rule 8 of the PRA Rulebook).

As is presently the case, the PRA’s expectations of risk management will increase in proportion to the size of the concentration and the risk it poses to the firm. In addition, where satisfactory mitigation is absent, we will make clear to firms that better management of counterparty default risk is required and, where necessary, take a proportionate approach to ensure that firms have effective risk management systems in place. The PRA’s expectation is that implementation of Solvency II does not, therefore, make it appropriate for firms to unwind mitigation currently in place unless other suitable actions are first taken to satisfy the requirements referred to above.

The PRA’s expectations may be revisited following the implementation of Solvency II and any changes will be communicated accordingly.

Solvency II waivers and modifications

The implementation of Solvency II will be accompanied by substantial changes to the PRA Rulebook. All waivers and modifications that are still in effect when rules fall away will themselves expire as of the date the rules are no longer in force. This means that most of the current waivers and modifications in force will expire on 31 December 2015.

The PRA is unable to grant waivers to any rules that are transposed from EU directives or that emanate directly from Solvency II regulations. There are, however, specific supervisory approvals set out in the Solvency II Directive and information on how to apply for these on the PRA website. Firms should contact their supervisor should they have further questions regarding waivers and approvals under Solvency II.

Solvency II national specific templates

As rules established by the PRA, national specific templates (NST) are eligible for waivers under s138A of FSMA. The PRA does not, however, anticipate many instances where a waiver to NSTs would be appropriate. NSTs are not expected to impose material one-off or ongoing incremental costs on firms as in most cases the information required is already produced and used by firms for other purposes. Where this is not the case, the PRA has designed the NSTs to ensure that any costs associated with the collection, preparation and submission of the required information are likely to be minimal.

Yours sincerely

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Director, Life Insurance

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Director, General Insurance

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Annex 1

Risk margin methodologies – main findings from the BSR

1. **Risks included in projected SCRs -** the PRA considers that the most informative methodology documents included the following information relating to the risk margin calculation of firms:
   - confirmation that the same underwriting risk types as in the main SCR calculation have been included in the risk margin calculation;
   - consideration of the means by which market risks would be minimised, with reference to the full term of the liabilities and available hedging instruments; and
   - evidence that residual market risks across all lines of business have been considered, including quantified estimates to justify the exclusion of immaterial residual risks from the risk margin calculation.

2. **Projection of future SCRs -** Guideline 61[1] of EIOPA's Guidelines on the valuation of technical provisions requires firms to assess whether a full projection of all future SCRs is necessary in order to reflect the nature, scale and complexity of the risks underlying their insurance and reinsurance obligations in a proportionate manner. The PRA considers that the most effective approaches were those that made use of an exact method of SCR projection for the most material risks (eg long-tailed liabilities) by applying the relevant stresses to the projected balance sheet.

   Where firms have followed EIOPA simplifications, the PRA considers that the most effective approach was taken by firms which included evidence or confirmation that the simplifications are proportionate to the risks that they face.

   Where a driver-based approximation method has been used, the PRA considers that the most informative methodology documents included a clear rationale behind the choice of drivers and any additional adjustments, for example:
   - consideration of expected changes in the exposure, as well as the level of risk per unit of exposure, as the volume of business runs off;
   - the relationship between future SCRs and the volume of business, and how this changes over time; and
   - rejecting the use of 'best estimate liabilities' as a driver of the estimate of the SCR where it switches from a negative value to a positive value over time.

   The PRA considers that the most informative methodology documentation also included evidence and, where material, validations using a more accurate calculation, to support the chosen method to project future SCRs.

   Firms are reminded that an internal model should be used only to project future SCRs provided that the internal model has been approved and the firm has determined that it is to be appropriate for that purpose, as per Article 37(2) of the Commission Delegated Regulation (EU) 2015/35 ('the Solvency II Regulation')[2].

   Firms are reminded that where they use the standard formula to project or validate future SCRs, they should ensure the method chosen adequately captures the risk profile of the undertaking, as for any alternative methods used to calculate the risk margin other than a full

[1] https://eiopa.europa.eu/Publications/Guidelines/TP_Final_document_EN.pdf (Paragraph 1.109)
[2] http://ec.europa.eu/finance/insurance/solvency/solvency2/index_en.htm

projection of the future SCRs, as per Guideline 61 of EIOPA's Guidelines on the valuation of technical provisions.

3. **Granularity of risks in SCR projections and diversification assumptions -** The PRA observed a varied level of granularity that firms applied to their business before projecting future SCRs. The most simplified approach taken by some firms was to project their SCR as a whole, whereas other firms split SCR into standard formula risk types such as counterparty and insurance risk. The PRA considers that the more accurate calculations are those which involve splitting insurance risks into more granular risk and sub-risk categories and by homogenous lines of business.

   Additional analysis undertaken by the PRA suggests that performing the calculation using homogeneous risk groups, such as by splitting out long-tailed risks (eg annuities and periodic payment orders), results in a material increase in risk margin when compared to performing the calculation on the business as a whole. Firms are reminded that where they have projected their SCR without splitting it into both homogeneous risk groups and by individual risks, they should assess whether this simplification is proportionate to the risk profile of the business as per Guideline 61 of EIOPA's Guidelines on the valuation of technical provisions, in particular, whether the approach has allowed for more diversification in future years than would actually be expected in reality.

   For risks where the direction of the biting scenario may either be based on an 'increase' or a 'decrease' of the risk factor (eg persistency), the PRA reviewed the most informative methodologies projecting the future SCR for both directions, taking the larger impact at each future point in time, and allowing for any impact on the diversification benefit arising from the change in the direction of the risk factor in the biting scenario to be captured properly.

   Where the correlation aggregation approach is used for future SCR calculations, the PRA considers that the most informative methodologies also considered the need for any non-linearity adjustments.

4. **Volatility adjustment and matching adjustment approvals in risk margin calculations -** Firms are reminded that EIOPA's Guidelines on the implementation of long-term guarantee measures[3] require that no long-term guarantee elements, including the matching adjustment, volatility adjustment and transitional measures, are to be included in any part of the risk margin calculation. For the avoidance of doubt, this applies not only to the discounting of future SCRs but also in the calculation of the future capital amounts required for risk margin calculations.

5. **Actuarial function and documentation -** Firms are reminded of Article 48(1b) of the Solvency II Directive[4] and Article 265 of the Solvency II Regulations, which set out the Actuarial Function's role to ensure the appropriateness of the methodologies and underlying models used; the assumptions made in the calculation; and the documentation requirements for the valuation of technical provisions (including the risk margin), respectively.

[3] https://eiopa.europa.eu/Publications/Reports/EIOPA-BoS-15-111_Final%20report_GL_Long_Term_Guarantee.pdf (Guideline 2, paragraph 1.10)

[4] This has been transposed into Section 6.1(1)(b) of the Conditions Governing Business Part of the PRA Rulebook.

Timetable of activity November to December 2015

Date	Description
November	Letter: communication of matching adjustment approvals, to relevant firms.
November	Publication: final supervisory statement on third-country insurance and pure reinsurance branches.
November	Publication: consultation paper on internal model approval process data review findings.
November	Publication: consultation paper on external audit of public disclosure requirements.
December	Letter: communication of internal model approvals, to relevant firms.

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Solvency II web updates since the last Directors' update

November 2015

On 3 November, Sam Woods, Executive Director of Insurance, delivered a speech entitled 'Solvency II: Approaching the try line' at the Association of British Insurers biennial conference in London. The speech considers what regulated insurers and the PRA need to do ahead of 1 January 2016.
Sam Woods, 'Solvency II: Approaching the try line' speech

October 2015

On 30 October 2015, the PRA published two supervisory statements for all UK firms within the scope of Solvency II, and where applicable, to third-country branches:
SS40/15 'Solvency II: reporting and public disclosure - options provided to supervisory authorities'
SS41/15 'Solvency II: applying EIOPA Set 2, System of Governance and ORSA Guidelines'

On 27 October 2015, the PRA published materials from a seminar held on 22 October 2015 for relevant category 3, category 4 and category 5 firms. The seminar gave an overview of Solvency II Pillar 3 submissions for smaller insurers due to submit in 2016 for the first time. Slides and a recording of the seminar are available on the 'Regulatory reporting' page below. Firms are reminded of the meeting notes available from the PRA's Solvency II regulatory reporting industry working group and testing sub-group on the 'Industry working group' page below. In addition an updated version of the BEEDS portal user guide is also now available on the 'BEEDS portal' page below, in Key Resources.
Regulatory reporting
Industry working group
BEEDS portal

On 15 October 2015, following the recommendations of the Fair and Effective Markets Review (FEMR), HM Treasury issued a consultation on the extension of the accountability regime, as well as changes to some areas relevant for banks, building societies, credit unions and PRA-designated firms as they prepare for implementation on 7 March 2016 - see the **Senior Managers and Certification Regime: extension to all FSMA authorised persons**. Readers may also find it useful to refer to the **Bank of England and Financial Services Bill**.

The new Senior Managers and Senior Insurance Managers regimes will be implemented on 7 March 2016 and firms should continue to make preparations to meet the deadlines, including 8 February 2016 for the submission of grandfathering notifications and relevant notifications. Firms should continue to refer to the dedicated Strengthening Accountability webpage.

September 2015

On 24 September 2015, the PRA published a letter from Sam Woods, Executive Director of Insurance Supervision, providing firms with information on Solvency II-related approvals for day 1 of the regime; applications to use the matching adjustment; applications to use an internal model; capital add-ons; and feedback on the preparatory phase data submissions received in July 2015.
Solvency II: Letter from Sam Woods, 24 September 2015

On 22 September 2015, the PRA invited firms that are due to submit Solvency II information for the first time in 2016 to a regulatory reporting seminar that will be held on 22 October 2015. Further details are available via the link below. Firms should also be aware that a third regulatory reporting question and answer document has been made available on the 'Detailed technical information' page. In addition, those working on the technical aspects of the Solvency II data submissions in the preparatory phase should be aware that a second version of the Bank of England's Solvency II XBRL filing manual is now available on the 'Taxonomy' page.
22 October 2015, PRA regulatory reporting seminar
Detailed technical information
Taxonomy

On 18 September 2015, the PRA published the materials from the smaller insurers briefing for category 5 insurers for Solvency II-affected firms, non-Directive firms and firms considering or pursuing an exit strategy. Materials from the event are available on the **Small insurers seminar** page.

On 16 September 2015, the PRA published an update letter from the PRA's Insurance Directors for all Solvency II-affected firms.
PRA Solvency II: Insurance Directors' update letter, 16 September 2015