

Supervisory Statement | SS4/15

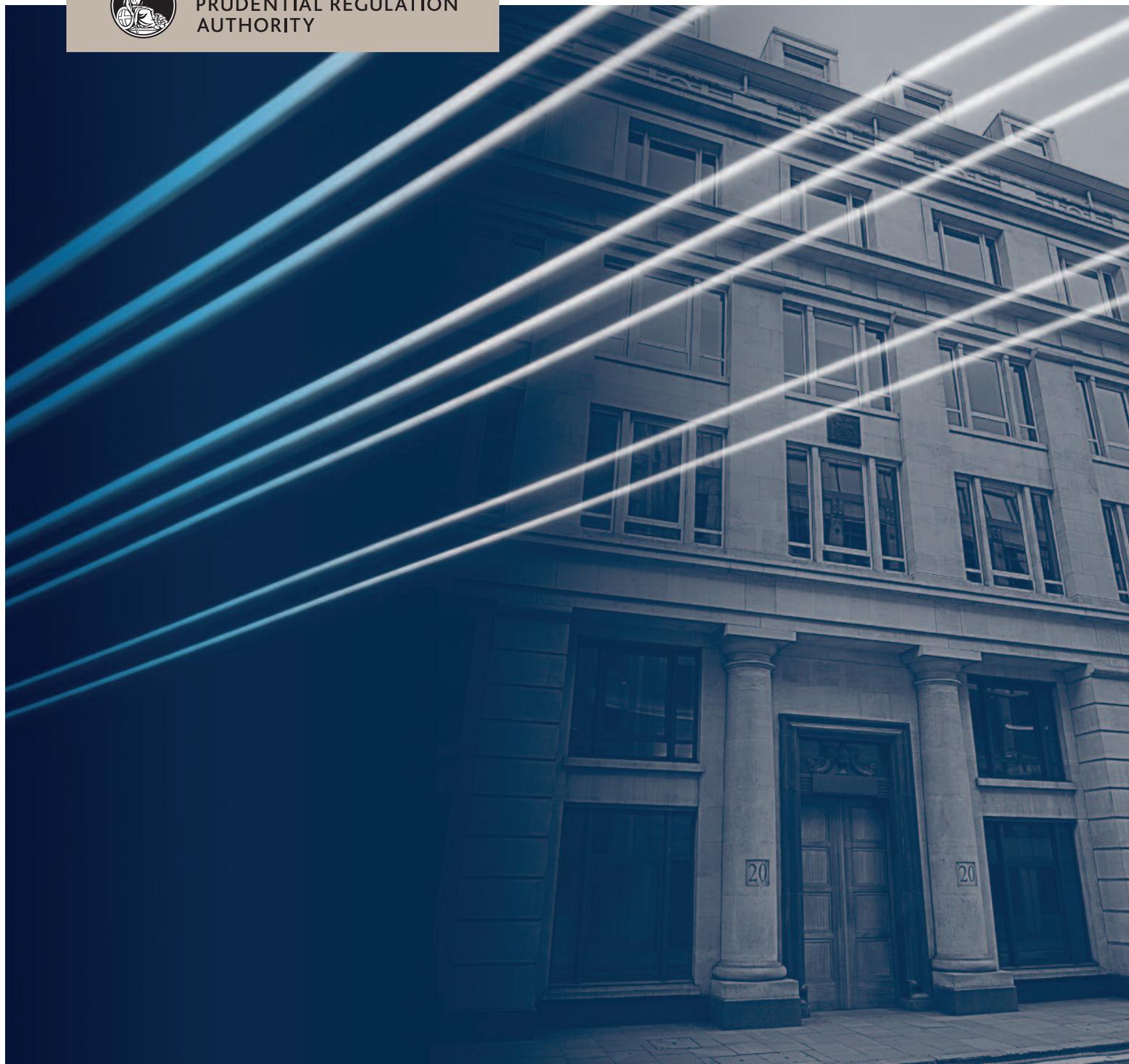
Appendix 2.4

Solvency II: the solvency and minimum capital requirements

March 2015



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1 Introduction

1.1 This supervisory statement is addressed to UK Solvency II firms and to Lloyd's. It sets out the Prudential Regulation Authority's (PRA's) expectations of firms in relation to the calculation of their solvency capital requirement (SCR) under Solvency II.

1.2 In particular, this statement expands on the following topics:

- undertaking specific parameters;
- significant deviations from the assumptions underlying the standard formula, internal models, or the system of governance;
- reversion to the standard formula;
- statistical quality standards; and
- calculation of the minimum capital requirement.

1.3 This statement should be read alongside the relevant European legislation, as well as the Solvency Capital Requirement Parts and Minimum Capital Requirement Part of the PRA Rulebook.

1.4 This statement expands on the PRA's general approach as set out in its insurance approach document.⁽¹⁾ 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. This statement is not expected to have any direct or indirect discriminatory impact under existing UK law.

1.5 This statement has been subject to public consultation⁽²⁾ and reflects the feedback that was received by the PRA.

2 Undertaking specific parameters

2.1 Under Article 104(7) of the Solvency II Directive, firms may, with the prior approval of the PRA, replace a subset of parameters with undertaking specific parameters when calculating the life, non-life and health underwriting risk modules. A firm may apply for this approval by applying to the PRA for a waiver.

2.2 Firms should be aware that undertaking specific parameters must be calibrated on the basis of the firm's internal data or on the basis of data which is directly relevant for the operations of the firm using standardised methods (see Article 104(7) of the Solvency II Directive).

2.3 The PRA may also require a firm, using its powers under section 55M of the Financial Services and Markets Act 2000 (FSMA), to replace a subset of the parameters used in the standard formula by undertaking specific parameters when calculating the life, non-life and health underwriting risk modules, where it is inappropriate to calculate the SCR in accordance with the standard formula because the firm's risk profile deviates significantly from the assumptions underlying the standard formula (see Article 110 of the Solvency II Directive).

3 Significant deviations from the assumptions underlying the standard formula calculation, internal model, and/or system of governance

3.1 Where it is inappropriate for a firm to calculate the SCR in accordance with the standard formula, because its risk profile deviates significantly from the assumptions underlying the standard formula calculation, then the PRA may require the firm to use an internal model to calculate the SCR, or the relevant risk modules of the SCR.

3.2 Article 37 of the Solvency II Directive contemplates the PRA applying a capital add-on to a firm in circumstances where there has been a standard formula significant risk profile deviation, an internal model significant risk profile deviation, a significant system of governance deviation, or a significant risk profile deviation following the application of the matching adjustment, volatility adjustment or transitional measures in Articles 308c or d, in circumstances where the conditions stipulated in article 37(1)(a), (b), (c) or (d) have been met. The PRA will use its powers under section 55M of FSMA in order to apply a capital add-on. The Solvency II Regulations also apply in relation to the imposition of a capital add-on.

Reversion to the standard formula

3.3 A firm may apply to the PRA for a waiver of Solvency Capital Requirement — Internal Models 8.1, if there are duly justified circumstances for the firm to revert to calculating the SCR on the basis of the standard formula.

(1) *The Prudential Regulation Authority's approach to insurance supervision*, June 2014; www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf.

(2) *PRA Consultation Paper CP16/14*, 'Transposition of Solvency II: Part 3', August 2014; www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1614.pdf.

3.4 If a firm fails to implement the plan to restore compliance referred to in Solvency Capital Requirement — Internal Models 9.1, the PRA may require the firm to revert to calculating the SCR in accordance with the standard formula.

Statistical quality standards

3.5 No particular method for the calculation of the probability distribution forecast is prescribed by PRA rules.

3.6 For the purposes of Solvency Capital Requirement — Internal Models 11.8(1), the PRA would only approve diversification effects to be taken into account in a firm's internal model dependencies within and across risk categories provided the firm satisfies the PRA that the system used for measuring those diversification effects is adequate.

3.7 If a firm cannot derive the SCR directly from the probability distribution forecast generated by its internal model, then the firm may apply to the PRA for a waiver of Solvency Capital Requirement — Internal Models 12.2 so that

approximations may be used in the process to calculate the SCR. In considering whether to grant such a waiver, the PRA will consider whether policyholders are provided with a level of protection equivalent to that set out in Solvency Capital Requirement — General Provisions 3.2–3.5 and Solvency Capital Requirement — Internal Models 3.1(2). The Solvency II Regulations contain additional requirements relevant to a firm seeking a waiver of Solvency Capital Requirement — Internal Models 12.2.

4 The minimum capital requirement

4.1 The PRA may, until 31 December 2017, require a firm to apply the percentages referred to in Minimum Capital Requirement 3.3 to the firm's SCR calculated in accordance with the standard formula. An example of when the PRA may require this would be where the output from the firm's internal model has deviated from the firm's risk profile and where the standard formula provides a better fit to the firm's risk profile.