

Supervisory Statement | SS5/15

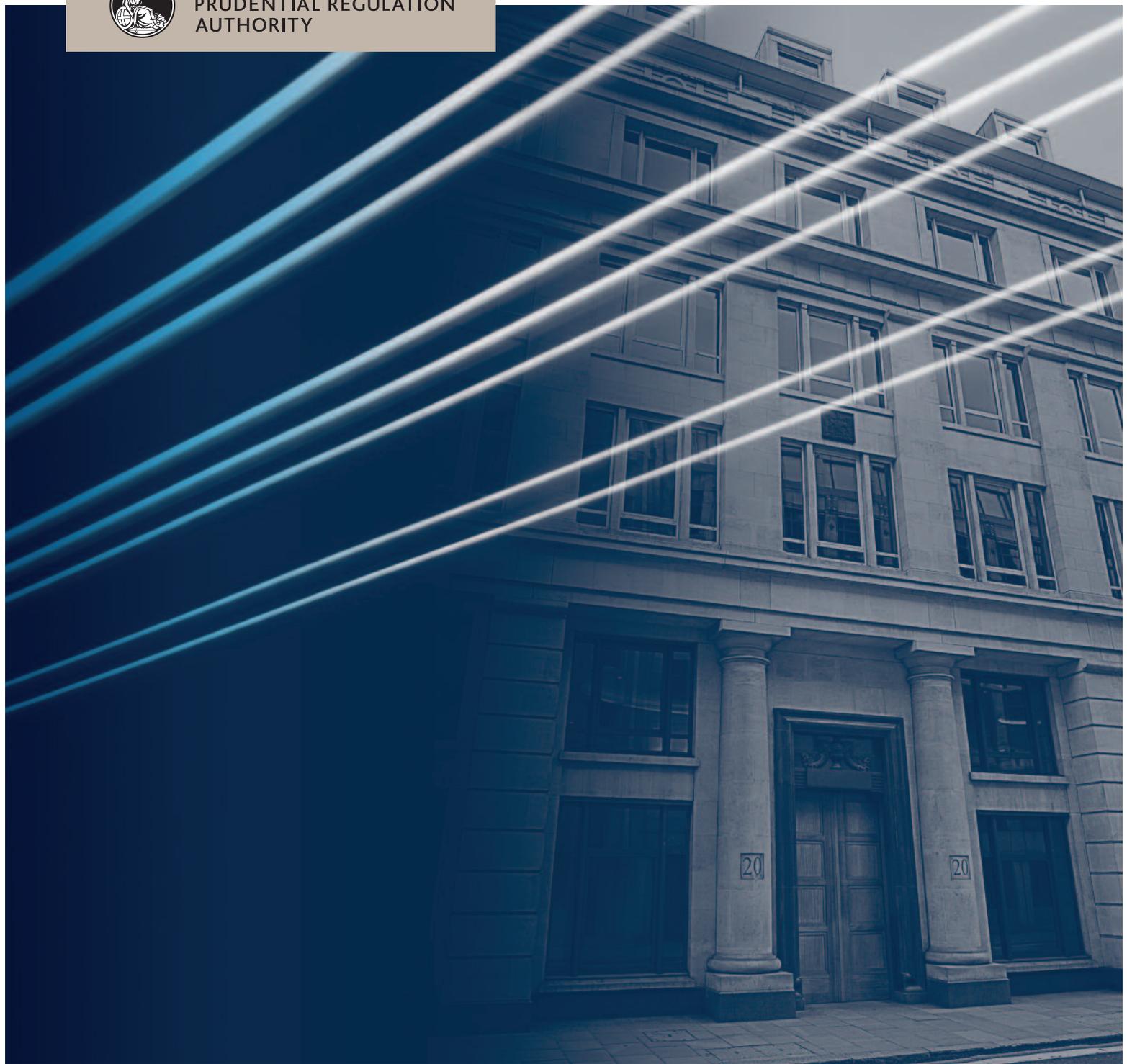
Appendix 2.5

# Solvency II: the treatment of pension scheme risk

March 2015



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY



25 November 2016 - this document has been updated, see  
<http://www.bankofengland.co.uk/pru/Pages/publications/ss/2016/ss515update.aspx>

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## 1 Introduction

1.1 This supervisory statement is of interest to all UK insurance firms within the scope of Solvency II and to the Society of Lloyd's. The Prudential Regulation Authority (PRA) expects firms to read this statement alongside all relevant European legislation and relevant Parts of the PRA Rulebook.

1.2 This statement sets out the PRA's expectations of firms in relation to defined benefit pension schemes and provides further clarity to firms which are the sponsor of a defined benefit pension scheme, or that are part of a group that contains a company which sponsors a defined benefit pension scheme. In particular this statement:

- explains what the PRA expects of firms that are not the legal sponsor of a defined benefit pension scheme but are part of a group that contains a company that sponsors a defined benefit pension scheme; and
- highlights areas to which firms should pay particular attention when considering the risks posed by a defined benefit pension scheme for the purpose of determining the solvency capital requirement (SCR). This includes risks arising both from pension schemes sponsored by the firm itself and those sponsored by another group company. This is relevant to the calculation of both the solo and group SCR.

1.3 This statement expands on the PRA's general approach as set out in its insurance approach document.<sup>(1)</sup> By clearly and consistently explaining its expectations of firms in relation to the particular area 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.

1.4 This statement has been subject to public consultation<sup>(2)</sup> and reflects the feedback that was received by the PRA.

## 2 Pension schemes sponsored by intragroup service companies and the impact on authorised firms

### Impact on the determination of own funds at a solo level

2.1 The Solvency II Regulations require that most financial liabilities, including pension liabilities, should be recognised

and valued in accordance with International Financial Reporting Standards.

2.2 There may be circumstances where International Financial Reporting Standards do not require a firm to recognise a pension scheme on its solo balance sheet.<sup>(3)</sup>

2.3 In making the determination as to whether to recognise a pension scheme on their balance sheets, firms should have particular regard to the requirement in International Accounting Standard 19 that a pension scheme should be recognised on the balance sheet of a firm if there is contractual agreement or stated policy in place under which the firm will contribute to the scheme.<sup>(4)</sup>

2.4 Firms should also pay particular attention to relationships with intragroup service companies, where provision of staff can be regarded as having been outsourced to the service company for the purposes of Rule 7 of the Conditions Governing Business Part of the PRA Rulebook. The Solvency II Regulations require that, where a firm outsources critical or important operational functions or activities, a written agreement should be entered into between the firm and the service provider which clearly defines the respective rights and obligations of each party.<sup>(5)</sup> Firms should consider whether a written agreement of this nature leads to a requirement under International Accounting Standard 19 to recognise the pension scheme on the balance sheet of the authorised firm.

2.5 Obligations in relation to a pension scheme sponsored by an intragroup service company will generally be recognised on the group's consolidated balance sheet, regardless of whether or not they are recognised on the balance sheet of an authorised firm. This will lead to obligations to a pension scheme being reflected in the calculation of group own funds and the group SCR.<sup>(6)</sup>

### Impact on the solo SCR

2.6 Firms should also consider the extent to which a pension scheme sponsored by an intragroup service company poses a risk to the safety and soundness of an authorised firm whether or not obligations in connection with a pension scheme are recognised on the solo balance sheet. An example of such a risk is that the firm might find it necessary to provide support for the scheme in the future in order to assist an intragroup service company on which the firm's operations depend.

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

(2) *PRA Consultation Paper CP24/14*, 'Solvency II: further measures for implementation', November 2014; [www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp2414.pdf](http://www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp2414.pdf).

(3) Article 9(1) and 9(2) of the Regulation (EU) 2015/35.

(4) Paragraph 41 of International Accounting Standard 19: [http://ec.europa.eu/internal\\_market/accounting/docs/consolidated/ias19\\_en.pdf](http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias19_en.pdf).

(5) Article 274(3) of the Regulation (EU) 2015/35.

(6) Article 335(1) of the Regulation (EU) 2015/35.

Firms should also consider the powers of the Pensions Regulator regarding entities that are considered to be connected to a pension scheme sponsor. These considerations would continue to apply if the sponsorship of the pension scheme were taken on by another group company, for example an intermediate holding company.

2.7 The PRA considers that pension schemes sponsored by intragroup service companies may pose a risk to authorised firms in that group. Therefore, where a firm intends to use an internal model to calculate its solo SCR, the model will need to take account of the risk posed by the pension scheme. Generally, such a model will need to take account of the risk of the firm needing to fund any existing pension scheme deficit that is not currently recognised on the firm's balance sheet, as well as the risk of the pension scheme's financial position deteriorating.

2.8 Where a firm decides not to model the risk posed by a pension scheme sponsored by an intragroup service company, on the basis that modelling this risk is not necessary, the firm will need to provide evidence that this is the case. Such evidence might include:

- evidence that the risk to the authorised firm would be addressed by the capital required to support the pension scheme being held elsewhere in the group and not in the authorised firm;
- evidence that the capital held elsewhere in the group is sufficient to support the pension scheme and that this capital is unencumbered; and
- evidence that this capital may be freely transferred to the authorised firm, including at times of stress, should the firm be required to support the pension scheme in the future.

2.9 A firm is required to assess the significance of the extent to which its risk profile deviates from the assumptions underlying the standard formula.<sup>(1)</sup> As part of this assessment, the PRA expects firms to consider the risks posed by a pension scheme sponsored by an intragroup service company. Depending on whether the obligations in relation to the pension scheme are recognised on the solo balance sheet and the materiality of the pension scheme risk to the firm, the risk may be dealt with through Pillar 2 measures or the firm may need to consider whether it should use a partial internal model to calculate the SCR, in the event that the standard formula does not reflect the firm's risk profile. The PRA will take a proportionate approach in assessing how the risk should be reflected.

2.10 Notwithstanding paragraph 2.9, the calculation of the group SCR should reflect the risks posed by any defined benefit pension schemes within the group, regardless of

whether or not the risks have been reflected in the solo SCR of any authorised entity.

### 3 Consideration of pension scheme obligations in the calibration of internal models with regard to credit spread risk

3.1 Internal models will need to cover the risk of credit spreads widening, where this is a material risk to the firm.<sup>(2)</sup>

3.2 International Accounting Standard 19 requires the pension scheme discount rate to be based on the yield on high-quality corporate bonds for which there is a deep market.<sup>(3)</sup> When a firm's internal model projects the value of the pension scheme liabilities following a hypothetical shock to credit spreads, this should consider which bonds will remain high quality with a deep market following this shock, and what their yield would be in these circumstances.

3.3 Given this, the PRA expects that firms will justify any allowance made in an internal model for pension scheme liabilities to change following a shock to credit spreads.

### 4 Consideration of restrictions on the recognition of a pension scheme surplus as part of the calibration of an internal model

4.1 Firms should consider requirements in the relevant International Financial Reporting Standards concerning the circumstances under which a pension scheme surplus may be recognised as an asset of the sponsor.

4.2 These considerations are relevant for determining the impact of the pension scheme on a firm's own funds. If the firm uses an internal model to calculate its SCR then restrictions on the ability to utilise a pension scheme surplus will also be relevant for determining the SCR.

4.3 The SCR calculated by an internal model should provide policyholders with a level of protection that is equivalent to a calibration corresponding to the value-at-risk of the firm's basic own funds subject to a confidence interval of 99.5% over a one-year period.<sup>(4)</sup> It is important for the firm to consider how basic own funds may change as a result of risk events. Part of this change may be driven by changes in the value of the assets and liabilities of a pension scheme.

4.4 When considering how basic own funds may change owing to risk events, firms should consider whether

(1) Conditions Governing Business 3.8(2)(c) of the PRA Rulebook.

(2) Solvency Capital Requirement — Internal Models 11.6 of the PRA Rulebook.

(3) Paragraph 83 of International Accounting Standard 19.

(4) Article 101(3) of the Solvency II Directive.

restrictions on the ability to utilise pension scheme surpluses would apply in those circumstances. In doing so, firms should consider any obstacles to covering losses with resources in the form of a surplus in a pension scheme. These obstacles might arise from any barriers to moving resources from the pension scheme to the entity.

## 5 Allowance for diversification between pension scheme risks and a firm's other risks in the calibration of an internal model

5.1 Firms should consider carefully the extent to which correlations exist and can be justified between the risks posed by a pension scheme and other risks that the firm faces. Relevant considerations include the extent to which:

- correlations exist owing to the firm and the pension scheme holding similar assets or assets whose values are expected to be correlated; or

- the pension scheme exposes the firm to demographic risks that are similar to the underwriting risks run by the firm. A particular example of strong correlations would be where a firm's insurance business exposes it to longevity risk.

5.2 Where correlations between risks are not perfect, Solvency II permits this diversification benefit to be reflected in the calibration of an internal model.<sup>(1)</sup> However, the firm will be required to justify robustly any allowance that has been made in an internal model for diversification between the risks associated with a pension scheme and the other risks faced by the firm.

## 6 Cost benefit analysis

6.1 The statement regards the benefits of providing appropriate levels of policyholder protection from exposure to pension risk as proportionate to the capital compliance costs, which are not expected to increase compared to the current approach.

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(1) Solvency Capital Requirement — Internal Model 11.8(1) of the draft PRA Rulebook as consulted in CP16/14.