BANK OF ENGLAND

Speech

Solvency II – a turning point

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Good morning and thank you for coming today. I am sure that many of you will be as relieved as I am to hear that I will not be starting with an update on the delays and uncertainty of Solvency II. For the first time, I am able to note that there has been a significant agreement reached during negotiations in Europe on both the timetable and key policy issues.

I want to use my time with you today to go through what these developments mean for our implementation of Solvency II. In particular, where we are now and what still has to be done. As you will see there is still some way to go.

Solvency II policy development

The first thing to say is that we now have certainty on the timetable for Solvency II. The Commission has been clear that the latest "quick fix" directive to set the date will be the last which means that the new regime will begin on 1 January 2016. In order to prepare for implementation, the transposition date for Member States has been set for 31 March 2015. This means that from 1 April 2015, Member States will be empowered to give Solvency II related approvals. This outcome is consistent with the planning assumption we have been using in the UK since late last year. But we and firms will need to step up our work to have everything in place to be truly ready for Solvency II.

This will include incorporating agreements reached on policy areas that had previously been uncertain or unstable. I realise that a number of firms downsized their Solvency II programmes and reallocated resources to other initiatives and priorities. It is now time to reassess priorities and make a concerted push to be able to demonstrate compliance with the new regime two years from now.

The trialogue discussions reached agreement on a number of areas to be included in the Omnibus II Directive. I'd like to focus on three today – the matching adjustment, equivalence and the transitional on technical provisions.

The first is the matching adjustment. The PRA welcomes the recognition that insurers that can closely match predictable liabilities face a reduced level of spread risk. But it's very important that firms make appropriate allowance for the residual risks that they face, for example the risk of unexpected asset defaults and downgrades. We expect to have discussions with firms about the effect of the matching adjustment on the calculation of both capital and technical provisions.

The second area is equivalence. In the context of the group solvency calculation it is anticipated that it will be possible for non-EEA territories to have their solvency regimes deemed by the European Commission 'provisionally equivalent' to Solvency II for a, potentially renewable, ten year period. This may result in local solvency standards being used when valuing subsidiaries of UK groups based in 'provisionally equivalent' jurisdictions. A number of details remain to be determined but in all discussions about equivalence, it is important to remember the end goal – that there is convergence towards genuinely comparable regimes and levels of policyholder protection across territories. In this context we are pleased to see the IAIS progressing on developing ComFrame and global insurance capital standards.

Third is the transitional arrangement that has been agreed for technical provisions. Firms will have 16 years to build up to holding full Solvency II technical provisions on their existing business as at 'day one'. During the transitional period there will be a 'floor' to ensure that firms will not be held to lower solvency standards than those of the pre-Solvency II regime of the Member State – so for UK insurers that will be ICAS or, where it bites, Pillar 1 of Solvency I. Given that the risk margin can introduce a very significant additional liability for some firms under the new regime, we welcome a sensible and smooth transition to the prudential standards of Solvency II. But we are also pleased that we have the safeguard of the transitional floor.

The Omnibus II Directive is tabled for a plenary vote in the European Parliament in the first quarter of 2014. A positive outcome will trigger the next stage of agreement of European legislation and regulation. We understand that the Commission aims to publish delegated acts next summer, but they hope to have a stable version ready by March. Implementing technical standards are expected to be produced by the Commission in three waves in the run up to the transposition date of 31 March 2015. The Commission expects to adopt the first wave of implementing technical standards in October 2014. And, in outline, that gives us the roadmap of the European policy needed for the implementation of Solvency II in 2016.

Alongside this, the PRA will be working to ensure readiness for the Solvency II regime. We will be putting in place the processes and systems needed to prepare for and operate in a Solvency II world, including the approval and supervisory review processes, and the IT capabilities needed for regulatory reporting.

Gearing up for Solvency II in 2016

So you will see that there is much to do to make sure that we are ready for 2016. The European Insurance and Occupational Pension Authority's – EIOPA's – preparatory guidelines are clearly very important and helpful in this regard and I will return to those shortly.

But, it is important that firms stay appraised of developments in delegated acts, implementing technical standards and guidance to be issued by the Commission and EIOPA. These are the instruments that will translate high level policy into practical reality.

This will represent a significant change in the way that many insurers will need to engage with material which sets regulatory requirements on them. The PRA Handbook will follow a different approach to our current INSPRU content. We will be adopting an 'intelligent copy out' approach – meaning we will be following the words of the Directive text as closely as possible. As such we will only depart from the Directive text in specific circumstances and will not be reproducing or providing significant interpretation or elaboration of

European legislative or regulatory material. Indeed, we are not entitled to do so. In some circumstances we may judge that general guidance is needed to clarify our expectations of firms – and in such circumstances, where it is possible to do so, we may issue supervisory statements.

Applying EIOPA's preparatory guidelines to PRA authorised firms

This brings me to EIOPA's preparatory guidelines and the PRA's supervisory statement published today.

EIOPA published guidelines for the preparation of Solvency II in October this year. The guidelines cover four areas that EIOPA considers fundamental to ensure effective preparation and convergence in the run up to Solvency II. We support EIOPA's approach and issued a draft statement for consultation in October setting out our expectations of firms in the preparatory period.

Overall, respondents welcomed the pragmatic and proportionate approach we are taking to apply EIOPA's preparatory guidelines. We have been very clear that the emphasis is on preparations for Solvency II and not its early implementation. We are not gold plating any of the guidelines. Our supervisory statement sets out how we shall apply EIOPA's guidelines to authorised firms affected by the Directive. The statement has separate chapters on each guideline area: systems of governance; the Own Risk and Solvency Assessment (ORSA); regulatory reporting; and pre-application for internal models. As many of the guidelines represent good practice in conformity with existing UK rules, they should not present an additional burden for many firms.

There is no need for me to repeat the contents of our statement here. Instead, I will highlight a couple of points before moving on to our expectations during the preparatory period.

The current supervisory regime does not go away. Firms will need to continue to meet existing regulatory requirements until Solvency II is implemented. We recognise that there are elements of the guidelines which will which require significant effort and resource. Where possible, and as we did for ICAS+, we will look for ways that firms may be able to use their preparations for Solvency II to meet the current requirements.

The PRA's expectations in the four areas of EIOPA's guidelines are aimed at all firms and groups affected by Solvency II. For all firms – including smaller firms - we expect preparations to be made in a way that is appropriate to the nature, scale and complexity of their business. This is what we mean by proportionality. It does not mean that firms can select which requirements to comply with or not. When it comes to groups, we will be asking firms to have discussions with their supervisor on how they intend to plan to be ready for the new regime, and the specific requirements it places on groups.

Own Risk and Solvency Assessment

In many respects, the ORSA can be considered the cornerstone of Solvency II. We expect to receive an annual ORSA supervisory report from all firms from January 2014 onwards; several firms have already developed something similar for internal purposes. To reflect the preparatory nature of the guidelines, we expect that by the second year the ORSA will be of a higher standard than the first but we will review these documents on a proportionate basis and give feedback where appropriate. Looking ahead, we attach considerable importance to the ORSA and the role that it will play in future to support the Threshold Condition that insurers must have appropriate non-financial resources and robust risk and capital management systems.

Reporting during the preparatory period

When looking at the guidelines on regulatory reporting, EIOPA has stated that only firms falling within certain thresholds will be expected to submit reports during the preparatory period. This does not however, remove the need for all firms to start getting ready for Solvency II reporting.

In November, we set up an industry working group so that the PRA and industry representatives could discuss the technical issues related to the implementation of Solvency II reporting. These include areas where policy is clear but data is difficult to provide or does not currently exist within the firm. It is also a useful forum to gain technical input on specific issues such as the reporting templates and taxonomy. We have published materials from the working group on our dedicated Solvency II webpages and will continue to do so.

We are very much aware of the concerns raised by the industry about the cost of the potential duplication of work and parallel running and we remain committed to reducing any unnecessary burden on firms where we can. We continue to think it reasonable to expect firms to be ready to provide Solvency II based reporting six months before implementation. This means that firms falling within the thresholds should be able to submit their reports in July 2015 which will be in line with the usual half-yearly financial reporting cycle for the majority of firms. Saying that, we acknowledge the concerns raised by some respondents to the consultation on our statement that the ability to comply with the guidelines is dependent on the availability of timely and complete reporting templates and taxonomy. We will review the practicability of the reporting timetable in the event of delays to this material being available. Make no mistake – this does not take away from the fact that firms will need to get ready for Solvency II reporting, with higher quality reports and better synchronised reporting.

Pre-application for internal models

I'm pleased to say that EIOPA's guidelines on pre-application for internal models support the on-going pre-application process that we have in place at the PRA. We will continue to work with firms in IMAP and through the ICAS+ process.

It is critical that firms keep to their allocated submission slot. The importance of this may be lost in the mists of time, so it may be useful for me to set this out clearly.

The submission schedule was created to plan and prioritise work in order for firms to be able to receive decisions on their model for 'day one'. When a slot is allocated, it is essential that firms make their submission to the required standard of quality, on time and to the agreed level of completeness, as we have allocated finite resource on that basis. We have also designed the system so that we review similar firms at a similar time, thus enabling us to ensure consistency of treatment. To date, we have exercised some flexibility with firms, particularly given the uncertainty on the timetable and policy. This will no longer be possible as we have a hard implementation date.

Firms that are not able to make their submission slot will lose it and will join the end of the queue. This is not a decision we have taken lightly, not least because we are aware that the repercussions for some firms of not achieving model approval are potentially severe. But equally it is one which we are perfectly prepared to take, and have been clear with firms that we expect them to have contingency plans in place to deal with a situation where their model is not approved.

We have said before, and I will say again, we make no apology for being robust in our approach to internal model approval. Models must meet the required tests and standards, capture all quantifiable risks, and deliver prudentially sound outcomes in a range of scenarios and over time.

Sharing information and experiences

We know from our work with insurers on Solvency II that it is useful to share information and experiences as we all prepare for the new regime. During the preparatory period we will continue to do this as far, and as soon, as we are able and we encourage the industry to do the same.

For internal model firms, we have compiled examples of good and bad practice in helping us to review the documentation submitted to us during the internal model approval process. We are publishing that on our dedicated Solvency II pages today and encourage firms to refer to it.

We have also invested significant resource in our actuarial departments to produce a series of technical papers. It is our intention to share our views and summary findings with you in the New Year. This could be in the form of publications and/or a series of technical sessions. We know from industry feedback that you would welcome our views in some areas, which we hope will help improve the quality of IMAP submissions. Receiving better quality submissions will enable us to make more efficient use of our specialist resources and have more useful conversations with firms about their model.

I've talked about pre-application for internal model firms because this is where our activity has been, and will continue to be, the most intense. But the majority of UK insurers will be relying on the standard formula to calculate the Solvency Capital Requirement – or SCR.

In my letter to firms in May, I set out our approach for standard formula firms. I said then that we were considering a number of areas and circumstances in which the standard formula may not be appropriate, for example, in capturing pension risk. We are still waiting for the finalised standard formula calibrations in the Level 2 text. In the meantime, firms should continue to ensure that their chosen method to calculate their Solvency II SCR is suitable, and where necessary, consider whether it is appropriate to use undertaking specific parameters, or a partial internal model, where the standard formula does not adequately reflect the firm's idiosynchratic risk profile.

There will also be a number of Solvency II related approvals that firms will need to make to us in advance of 1 January 2016. More information on these is expected in the delegated acts and implementing technical standards in the coming year.

Looking ahead

Looking out, two years may seem like a reasonably long period of time. However, working backwards - and taking into account the time needed to make decisions - shortens it markedly from 24 months to closer to 15 months - which ties in with transposition on 31 March 2015.

So you can see that there is a lot to do and getting to January 2016 in good shape is only the start. If our experience of Solvency II is the same as for the introduction of the ICAS regime in the UK – and taking into account transitional arrangements - we may be looking at the best part of a decade for us and firms to be able to use the regime. It is worth remembering that ICAS is both much simpler in design and ambition and also much less prescriptive than Solvency II.

Looking beyond Europe, we are also at a point of fundamental change in the development of global insurance regulation .The IAIS is working towards a common supervisory framework for internationally active insurance groups through its ComFrame initiative. It has also recently announced that it will develop a risk-based global insurance capital standard within ComFrame by 2016. So European insurance regulation will have the ability to both shape – and in turn be shaped by – wider global developments.

These initiatives in insurance supervision – more immediately in Solvency II but closely followed by the work of the IAIS – makes it imperative for firms stay abreast of developments and commit the time and resource needed to keep pace. We are going through a period of unprecedented change and both firms and supervisors have to adapt to secure the benefits. As you will see, whilst much has been accomplished, there's much more for us all to do.