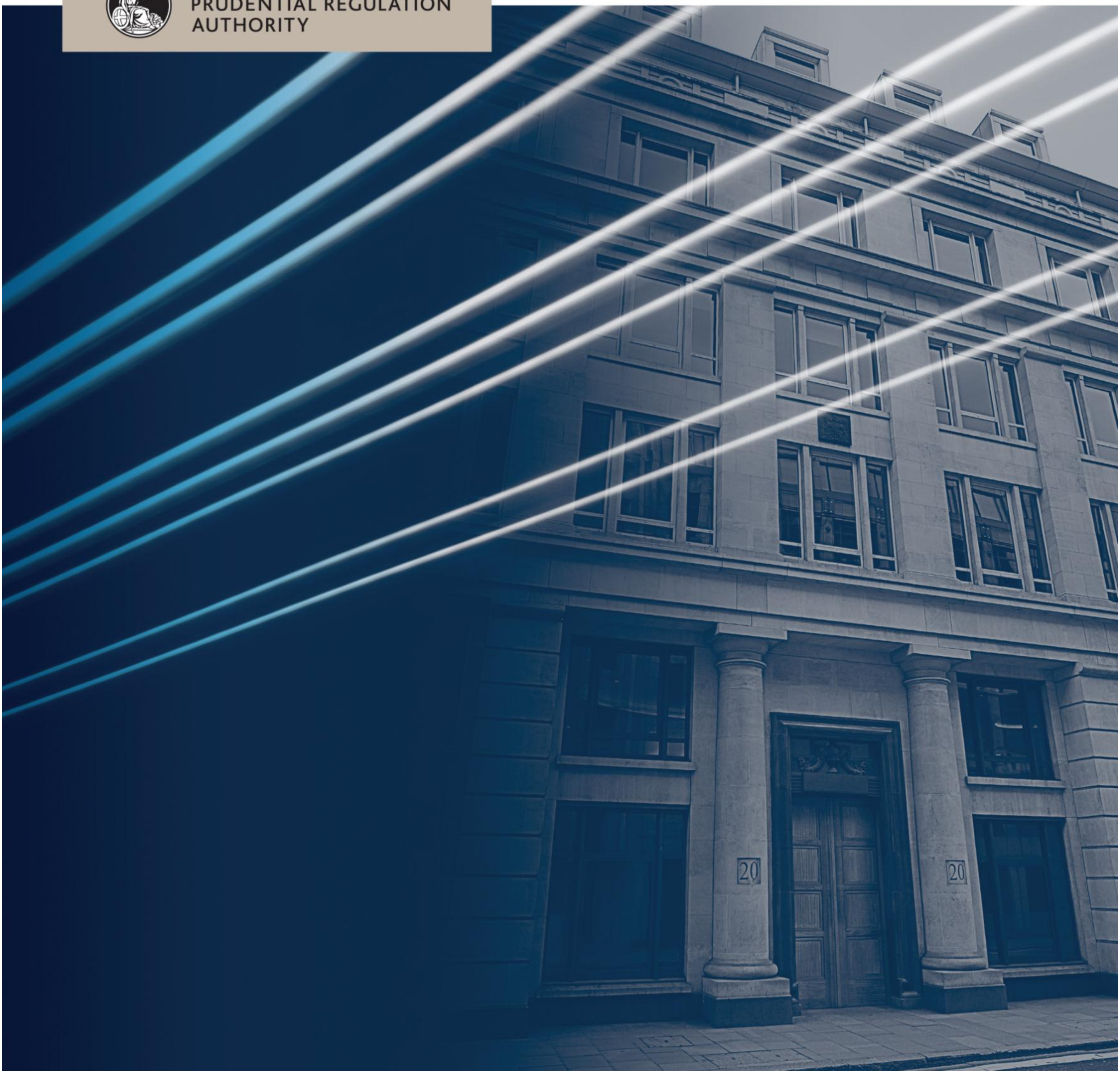
Supervisory Statement | SS30/15

Solvency II: treatment of sovereign debt in internal models

July 2015

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

Prudential Regulation Authority, registered office: 8 Lothbury, London EC2R 7HH.
Registered in England and Wales No: 07854923

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Supervisory Statement | SS30/15

Solvency II: treatment of sovereign debt in internal models

July 2015

1 Introduction

1.1 This supervisory statement is addressed to UK Solvency II firms and to Lloyd's. The Prudential Regulation Authority (PRA) expects firms to read this statement alongside all relevant European legislation and the Solvency Capital Requirement Parts of the PRA Rulebook.[1]

1.2 This statement expands on the PRA's general approach as set out in its insurance approach document.[2] By setting out the PRA's expectations of firms in relation to the treatment of sovereign debt in internal models, this supervisory statement promotes the safety and soundness of the firms it regulates and contributes to securing appropriate degree of protection for policyholders.

1.3 For the purpose of this statement, sovereign debt refers to exposures in the form of bonds and loans issued or guaranteed by counterparties including but not limited to:

(a) central banks;

(b) central governments; and

(c) supranational organisations.

1.4 The PRA has considered matters to which it is required to have regard, and 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.

2 Compliance with Solvency II requirements

2.1 Solvency Capital Requirement - General Provisions 3.3 requires that the Solvency Capital Requirement must be calibrated so as to ensure that all quantifiable risks to which a firm is exposed are taken into account. The PRA considers that sovereign debt as an asset class can give rise to market risk and credit risk as defined in the Glossary Part of the PRA Rulebook. The PRA also expects firms to consider a particular basis risk that arises under Solvency II when sovereign bonds are used to back liabilities. Specifically, the discounting of liabilities with the 'relevant risk-free rate term structure'[3] derived from interest rate swaps may give rise to a risk that the spread between sovereign bond yields and the relevant risk-free rate changes ('gilt-swap spread risk').

2.2 Firms should include these risks in their internal model, unless it can be demonstrated that these are not material. Failure to include material risks within the scope of the internal model will mean that the model does not fulfils the requirements set out in Solvency Capital Requirement - Internal Models 10 to 15.

---

1 Solvency Capital Requirement- General Provisions and Solvency Capital Requirement –Internal Model http://www.bankofengland.co.uk/pra/Documents/publications/ps/2015/ps215.pdf.

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

3 Commission Delegated Regulation (EU) 2015/35, Chapter III section 4.