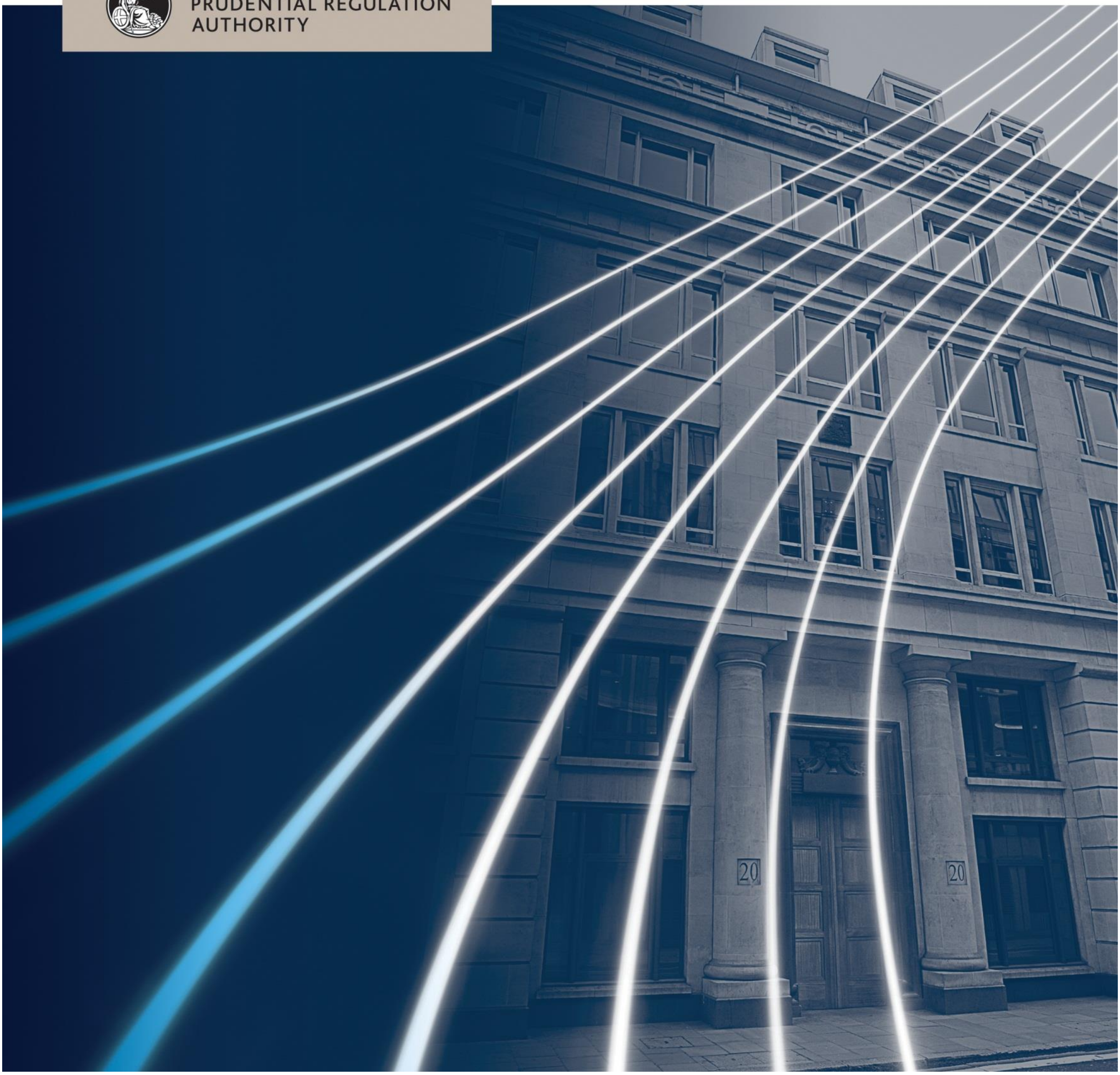
Policy Statement | PS9/20

Solvency II: Income producing real estate loans and internal credit assessment for illiquid, unrated assets

April 2020

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 23/19 'Solvency II: Income producing real estate loans and internal credit assessment for illiquid, unrated assets'.[1] It also contains the PRA's final Supervisory Statement (SS) 3/17 'Solvency II: Illiquid unrated assets' (see Appendix).

1.2 The PS is relevant to UK insurance and reinsurance companies holding or intending to hold income producing real estate (IPRE) loans. It is also relevant to firms investing in illiquid, unrated assets within their Solvency II (SII) matching adjustment (MA) portfolios.

Background

1.3 In CP23/19 the PRA consulted on proposed expectations of firms in respect of their modelling of IPRE loans within their Solvency II internal models. It also proposed amendments to its expectations in respect of the use of internal credit assessments for assigning fundamental spreads for illiquid, unrated assets.

Summary of responses

1.4 The PRA received six responses to the CP. Respondents generally welcomed the PRA's proposals but made a number of observations and requests for clarification which are set out in Chapter 2.

Changes to draft policy

1.5 The PRA must consider representations that are made to it in accordance with its duty to consult on its general policies and practice and must publish, in such manner as it thinks fit, responses to the representations.[2]

1.6 Having considered the feedback received, the PRA has decided to maintain the expectations set out in CP23/19, but has revised the wording of the SS to clarify some of these expectations. These changes are described in full in Chapter 2 of this PS.

1.7 The PRA considers that these changes make the final policy clearer and do not result in any additional requirement on firms compared to the original proposals. As a result, the PRA has not updated the cost benefit analysis or assessment of the impact on mutuals from the CP.

Implementation

1.8 The expectations set out in the attached SS will come into effect with the publication of the PS on Thursday 2 April 2020. The PRA reminds firms of its 'Approach to Insurance supervision', in particular the focus 'on those issues and those firms that, in our judgement, pose the greatest risk to the stability of the UK financial system and, in the case of insurers, to policyholder protection.'[3] It also refers firms to the published measures aimed at alleviating operational burdens on PRA-regulated insurers in the wake of the Covid-19 outbreak.[4]

1.9 The policy set out in this PS has been designed in the context of the UK's withdrawal from the European Union and entry into the transition period, during which time the UK remains subject to

1 September 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-ipre-loans-and-internal-credit-assessments-for-illiquid-unrated-assets.
2 Sections 2L and 2N of the Financial Services and Markets Act 2000 (FSMA).
3 October 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/pras-approach-to-supervision-of-the-banking-and-insurance-sectors.
4 https://www.bankofengland.co.uk/news/2020/march/boe-announces-supervisory-and-prudential-policy-measures-to-address-the-challenges-of-covid-19.

European law. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the European Union take effect.

1.10 The PRA has assessed that the policy would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018' for further details.[5]

2 Feedback to responses

2.1 The PRA has considered the responses received to the CP. This chapter sets out the PRA's feedback to those responses, and its final decisions. The structure is broadly aligned with the sections in the CP. Minor clarifications and amendments have also been made to the SS in response to helpful feedback on points which lacked clarity.

Chapter 1 – Overview

Implementation date

2.2 The PRA proposed an implementation date for the proposals of Tuesday 31 March 2020. This date was proposed as the PRA expected publication of this Policy Statement and updated SS3/17 by that point.

2.3 Three respondents asked for an appropriate amount of time to implement the expectations included in the CP. This included the proposal for the 'expected enhancements to firms' internal credit assessments and modelling of IPRE loans to form part of firms annual review cycle'.

2.4 After considering the responses, the PRA has decided that the expectations will apply from the publication date of this PS and updated SS3/17 (ie Thursday 2 April 2020). The cost benefit analysis in paragraph 4.4 of the CP stated that 'the proposals provide clarity and consistency on the PRA's expectations… but does not impose additional requirements'.

2.5 The PRA considers that delaying implementation of the expectations in Chapter 4 of the SS would not be consistent with the existing need for firms to evidence compliance with the prudent person principle (PPP).[6] Firms must also ensure that the Solvency Capital Requirement (SCR) captures all quantifiable risks to which they are exposed, whether using the standard formula or the internal model.[7] The PRA considers these expectations to provide clarity on what is already required under Solvency II in respect of specific asset classes. However, any firm concerned that it does not meet the expectations should discuss with its supervisor an appropriate timescale to improve its risk identification exercise, internal credit assessment and/or modelling process.

Chapter 2 – IPRE lending

Risk Identification

2.6 The PRA proposed that whether they are using the standard formula or internal model, firms should complete a comprehensive risk identification exercise for IPRE loans in order to evidence compliance with the requirements of the PPP and the calculation of the SCR. This would evidence

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5 April 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

6 As set out in Chapters 2-5 of the Investments Part of the PRA Rulebook (which transpose Article 132 of the Solvency II Directive (2009/138/EC) ('Solvency II').

7 As set out in Solvency Capital Requirement – General Provisions 3.3 of the PRA Rulebook.

compliance with the SII requirement for the SCR to capture all quantifiable risks to which they are exposed.

2.7 Two respondents strongly supported the PRA's proposal. They noted that they found the detail proposed by the guidance in the CP helpful, such as the expectation for an IM to take 'into account the property risks that may impact the value of collateral'.

2.8 One respondent queried how proportionality could be applied to the proposal. Two respondents argued that the expectation that firms should consider all relevant systemic and idiosyncratic risks associated with their IPRE loans is not achievable, and suggested a proportional approach to risk identification with risk materiality as a key consideration.

2.9 The PRA Rulebook requires a firm's risk management system to 'cover the risks to be included in the calculation of the SCR… as well as the risks which are not or not fully included in the calculation.'[8] Asset-liability management and investments are specifically included, and therefore, risk identification should form a core, primary part of an effective risk management system. The application of proportionality should consider the materiality of the risk. Materiality is defined in the Delegated Regulation as the level at which information could influence the decision-making or the judgement of the users of that information, including the supervisory authorities.[9] The SS therefore does not provide a definition of materiality. Several expectations in the proposed Chapter 4 of the SS specifically include firms' consideration of the materiality of identified risks.

2.10 As set out in the SS, in order to comply with the Investments Part of the PRA Rulebook, the PRA expects firms to complete a comprehensive risk identification exercise. The PRA agrees that materiality is a relevant consideration and the level of detail in the identification and assessment of each risk will depend on the current and potential significance of the risk. Paragraph 2.8B of the SS has been amended to make this clearer.

2.11 The SS (paragraphs 2.6 and 2.7) includes guidance about the PRA's proportionate approach when assessing firms' credit quality step (CQS) mapping of an exposure to a particular asset class. The PRA will similarly use its supervisory judgement when assessing if firms meet the expectations. The extent of a review may vary between firms depending primarily on differences in their current or proposed risk exposures. This has now been made clear in paragraph 4.1 of the SS.

2.12 One respondent asked for clarification on whether the PRA's proposal was for a firm to have separate, but consistent, risk identification exercises for the internal credit assessment and calculating the SCR or a single risk identification exercise covering both purposes.

2.13 The PRA considers that there should be a single risk identification exercise for the asset, which then informs both the internal credit assessment and SCR. For each identified risk, a firm should then determine whether it is appropriate to include it in the internal credit assessment and/or the SCR. Paragraph 4.11 of SS3/17 similarly includes that 'whilst the SCR may be calibrated to cover only a subset of the risks identified in the risk identification exercise, eg where some risks have been fully mitigated by the firm, firms are expected to clearly justify and explain any exclusions of risks identified in the risk identification exercise from the SCR calibration.' The PRA has updated paragraph 4.8 in the SS to provide extra clarity on this point.

8 PRA Rulebook Rule 3.1(2) Conditions Governing Business.
9 Articles 222 and 305 of the Commission Delegated Regulation.

2.14 The PRA proposed that the output of the risk identification exercise should, where relevant, inform a firm's assessment of its standard formula appropriateness and/or the scope, methodology and calibration of an internal model.

2.15 One respondent agreed with the proposal but noted that it could be challenging for non-quantifiable risks which are qualitatively accounted for in the internal rating process.

2.16 Paragraphs 4.10-4.12 of the SS covers the PRA's expectations on the use of the risk identification exercise output in both the internal model and any standard formula appropriateness assessment. In particular 4.11 discusses the possibility of the SCR covering a subset of risks identified in the risk identification exercise, and the expectations of firms in justifying exclusions and demonstrating that sufficient risk coverage is achieved. The PRA considers that these paragraphs sufficiently reflect the challenge of incorporating qualitative factors in the SCR calculation.

2.17 One respondent also suggested minor textual changes to Chapter 2 of the CP which describes the proposed new chapter on IPRE lending. However, only the Appendix of the CP will form part of the updated SS.

Chapter 3 Internal credit assessments for illiquid, unrated assets

Broad consistency with ECAI issue ratings

2.18 The PRA proposed an elaboration and expansion of the existing expectations included in SS3/17 around the use of internal credit assessments for assigning fundamental spreads. These proposals aimed to clarify how firms can demonstrate the robustness of their internal credit rating assessments and hence provide assurance over the assigned credit quality step (CQS) and corresponding fundamental spread (FS). A key existing expectation that was expanded on in the proposals is the PRA's view that the CQS to which an internal credit assessment maps should lie within the plausible range of CQSs that could have resulted from an issue rating given by an External Credit Assessment Institution (ECAI).

2.19 One respondent expressed explicit support for these proposals. Two respondents asked the PRA to consider revising its proposals to align better with an over-arching objective to reduce reliance on external ratings.

2.20 The PRA notes that this challenge has been previously raised during the 2017 consultation on SS3/17.[10] The PRA reiterates its response (from PS14/17) that it 'does not consider that the principle of broad consistency conflicts with the aim of reducing sole and mechanistic reliance on ECAI ratings.'[11] In establishing this principle, the PRA is seeking to ensure that firms' internal credit assessments are sufficiently robust and that they consider the full range of sources of credit risk in a manner no less rigorous than a regulated credit rating agency.

Internal credit assessment methodology and criteria

2.21 A firm may decide to base its internal credit assessment methodology for a particular asset class on an ECAI's published credit rating methodology that is applicable for that asset class. In this case, the PRA proposed that the firm apply that methodology holistically and for it not to be used selectively.

10 December 2016: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/equity-release-mortgages.
11 July 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/equity-release-mortgages.

2.22 One respondent asked the PRA to clarify the intent behind the statement (in paragraph 2.8F of the draft SS) that, 'the PRA also expects the firm will apply that methodology holistically and for it not to be used selectively'.[12]

2.23 The PRA considers that an ECAI's published methodology should only be applied in full and in the manner in which that ECAI would be expected to apply its own criteria. Paragraph 2.8F of the SS has been updated to clarify this point. One example is that an ECAI's stresses and methodology should be considered together. We would not expect an ECAI methodology to be used with adjusted stresses as this threatens the overall integrity of the ECAI approach. Where an ECAI's criteria are applied in a manner that the authoring ECAI would not use, this could lead to upward bias in rating versus the ECAI. The PRA considers that all such examples that can lead to an upward bias in rating versus the ECAI would not demonstrate broad consistency between the CQSs resulting from firms' internal assessments and ECAI issue ratings.

Conflicts of interest

2.24 The PRA proposed that firms should evidence that individuals who are free of conflicts of interest have performed the credit rating methodology and criteria development and approval, internal credit assessment and CQS mapping.

2.25 One respondent commented that a paid-for service can never be wholly unconflicted and instead proposals should focus on how well potential conflicts are managed. Another respondent noted that the proposal would apply to all internally rated asset classes.

2.26 The PRA agrees that the key objective of the proposal, which is relevant to all internally rated assets, is appropriate management of any conflict of interest. The PRA has updated the wording in the SS to remove any misunderstanding.

Chapter 4 Risk Identification and modelling of IPRE loans

Scope of Chapter and Definition of IPRE loans

2.27 Four respondents challenged the proposed definition and discussion of common features of IPRE (paragraphs 4.2 & 4.3 of the draft SS). The main points raised were:

- the proposed definition covered a small proportion of a respondent's portfolio;
- lack of clarity provided by the definition;
- confusion resulting from the discussion of the use of SPVs; and
- a request to include examples of IPRE loans.

2.28 A number of respondents additionally noted that some of the expectations in the draft SS were not necessarily specific to IPRE (outsourcing, risks introduced by potential third party actions and investment mandates).

2.29 Having considered the responses, the PRA has decided to amend the SS to provide greater clarity. In particular, the definition of IPRE in paragraph 4.2 is now more closely consistent with that proposed by the Basel Committee on Banking Supervision, and paragraph 4.3 has been amended to

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12 Appendix of CP23/19 'Solvency II: Income producing real estate loans and internal credit assessment for illiquid, unrated assets' https://www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-ipre-loans-and-internal-credit-assessments-for-illiquid-unrated-assets.

achieve greater clarity.[13] The PRA also notes that the definition of IPRE has been used as a reference in setting these expectations, however it does not consider that the applicability of the expectations is necessarily limited to the definition. In particular, in paragraph 4.1 and 4.2 the PRA explains that the expectations may be more widely applicable. The PRA has therefore decided not to include examples in the definition to avoid confusion.

The role of the risk identification exercise

2.30 One respondent requested that the PRA include examples of secondary risks in paragraph 4.11. The PRA has chosen not to do this in the SS as such risks may vary considerably by firm.

The process and scope of the risk identification exercise

2.31 One respondent commented on the list of risks noted in paragraph 4.19 of the draft SS. The PRA notes that this is a minimum list (and therefore is not intended to be exhaustive). The PRA further notes that this relates to the risk identification exercise, rather than being specific to internal models.

2.32 The PRA proposed in paragraph 4.20 that firms should demonstrate that they have appropriate skills and experience to implement the controls and risk management actions assumed in the management of IPRE loan exposures within the internal model. One respondent noted that this is relevant to both standard formula and internal model firms. The PRA has removed the final sentence of this paragraph which referenced internal model-specific expectations to avoid confusion.

Impact of IPRE loan management, including workout capabilities on risk profile

2.33 The PRA proposed expectations around the treatment of technical defaults. One respondent noted that any resultant actions taken would be dictated by circumstances at the time of the event. The PRA acknowledges this, and expects firms to consider the circumstances under which it may reasonably expect to take different actions.

Risk calibration and validation of internal models

2.34 One respondent requested that the PRA specify an aspect of the Use Test that is relevant to the expectations set out in paragraph 4.30 of the draft SS. The PRA notes that firms should consider all aspects of the Use Test when developing their internal models as all will be considered as part of PRA review of model (change) applications. An example has not been specified as the PRA does not seek to give precedence to certain aspects of the Use Test.

A one-year stress on IPRE loans

2.35 One respondent asked whether the reference to 'the IPRE loan transition matrix' in paragraph 4.34 referred to the content of paragraph 4.33. The PRA can confirm that this is correct and has updated paragraph 4.33 to clarify this point.

Stressed fundamental spread on IPRE loans

2.36 The PRA stated that it would ordinarily expect that firms would not assume a zero loss given default (LGD) on IPRE loans, if the modelling of LGD is applicable to a firm's methodology. One respondent noted that it may be possible to achieve this implicitly rather than explicitly. The PRA notes that all firm specific approaches will be considered on a case-by-case basis.

2.37 The PRA also included a proposal that firms should consider the rate of recovery against the collateral and security upon default that is achievable within the two month window in order to restore compliance with the Matching Adjustment conditions. Two respondents expressed concern

[13] Basel Committee on Banking Supervision –The Basel Framework: IRB approach: overview and asset class definitions: https://www.bis.org/basel_framework/chapter/CRE/30.htm.

with the reference to the two month window to re-establish MA compliance. The PRA notes that this proposal relates to the calculation of a stressed FS (ie step 2 of the PRA five-step framework, as discussed in SS8/18).[14] These proposals do not relate necessarily to step four (ie rebalancing) of the PRA five-step framework, which is covered separately in the SS.

2.38 The PRA stated in paragraph 4.37 of the draft SS that 'basis risk….may be more material than in the case of corporate bond holdings'. One respondent asked the PRA to provide additional justification for this assertion. The PRA understands that relevant data may be limited for some illiquid assets, given their heterogeneous nature and the relatively low levels of observed trades. This can introduce basis risk that may not be present in relation to assets where data is more readily available.

2.39 The PRA set out a list in the SS (paragraph 4.38) of expected components of property risk to be included within the stressed FS calculation. One respondent noted that the proposed drafting may infer a double-counting of risk. The PRA has included a note in this paragraph to establish that the list is not necessarily mutually inclusive.

The MA qualifying conditions in stress

2.40 The PRA proposed expectations around rebalancing by injecting IPRE loans into the MA portfolio. One respondent disagreed with the PRA's statement in the SS (paragraph 4.49) that 'this may be a material exercise'. The PRA acknowledges that circumstances will vary by firm, and considers this is evident in the use of the word 'may' in this case. Another respondent noted that it may be onerous to require injected assets to exhibit the 'same features' as those already in the MA portfolio. The PRA notes that this is consistent with the MA Implementing Technical Standard.[15]

2.41 A number of respondents made comments relating to the overall calculation of a stressed MA, on areas including granularity and calculation of a stressed FS relative to the FS produced by the European Insurance and Occupational Pensions Authority to calculate technical provisions. The PRA's expectations on the calculation of a stressed MA in internal models that are not specifically focussed on illiquid assets are discussed in SS8/18. They are not discussed further in this PS.

Validation

2.42 One respondent commented on the PRA's expectations around validation of the IPRE calibration using back-testing. The text in paragraph 4.55 has been updated to clarify that the PRA acknowledges that experience data may be limited.

2.43 One respondent requested guidance on how to assess the credibility of expert judgements used in modelling IPRE. Such approaches will differ by firm and will extend beyond IPRE modelling. The PRA expects each firm to set out its approach to the PRA in support of any model (change) application. One respondent questioned the meaning of the phrase 'to support the level of MA on IPRE loans' in the expectation noted in paragraph 4.54. Here, the PRA was referring to the fact that a firm cannot take credit for an MA benefit unless it can demonstrate that the MA qualifying conditions are met, and therefore the benefit is appropriate and supported.

14 July 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-internal-models-modelling-of-the-matching-adjustment-ss.

15 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0500&from=EN.

Appendix

Statement (SS) 3/17, 'Solvency II: Illiquid unrated assets', available at:
https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss