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Supervisory Statement | SS5/15

Solvency II: the treatment of pension scheme risk

November 2016

(Updating March 2015)

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1 Introduction

1.1 This supervisory statement (SS)[1] is of interest to all UK firms that fall within the scope of the Solvency II Directive ('the Directive'),[2] and to Lloyd's. It sets out the Prudential Regulation Authority's (PRA's) expectations of firms in relation to defined benefit pension schemes and provides further clarity to firms that 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 SS:

- 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.

1.2 Deleted.

1.2A This statement should be read in conjunction with the PRA's rules in the Solvency II Sector of the PRA Rulebook, in particular the Conditions Governing Business and the Solvency Capital Requirement Parts, and the PRA's insurance approach document.[3]

1.3 This SS expands on the PRA's general approach as set out in its insurance approach document. 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.

1.4 Deleted.

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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 Article 9(2) of the Solvency II Commission Delegated Regulation[4] (Delegated Regulation) requires 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.[5]

1 On 21 November 2016, this SS was updated – see appendix for full details.
2 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast).
3 Available at www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.
4 Solvency II Commission Delegated Regulation (EU) 2015/35 of 10 October 2014, supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).
5 Article 9(1) and 9(2) of the Regulation (EU) 2015/35.

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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 (IAS) 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.[1]

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 Conditions Governing Business 7. The Delegated Regulation requires 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.[2] Firms should consider whether a written agreement of this nature leads to a requirement under IAS 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.[3]

Superseded

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. 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 should 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 should take account of the risk posed by the pension scheme. Generally, such a model should 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 is expected to provide evidence that this is the case, which 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;
- the capital held elsewhere in the group is sufficient to support the pension scheme and that this capital is unencumbered; and

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1 Paragraph 41 of IAS 19: http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias19_en.pdf.
2 Article 274(3) of the Regulation (EU) 2015/35.
3 Article 335(1) of the Regulation (EU) 2015/35.

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- 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 Firms are required to assess the significance of the extent to which its risk profile deviates from the assumptions underlying the standard formula.[1] 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 need to cover the risk of credit spreads widening, where this is a material risk to the firm.[2]

3.2 IAS 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.[3] When a firm's internal model projects the value of the pension scheme liabilities following a hypothetical shock to credit spreads, the PRA will expect any change to the liabilities following this shock to be justified. Firms also 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 The approach taken should capture adequately the risks that the firm is exposed to. In particular, there is a risk that under stressed conditions:

- the market in some high quality corporate bonds may not be considered 'deep' and therefore using the yield on these bonds may not satisfy the requirements of IAS 19, even if an adjustment is made to ensure that they remain high quality; and
- there is a significant divergence between the IAS 19 deficit and the scheme funding deficit, increasing the likelihood that the firm is required to pay additional contributions to the pension scheme.

3.4 The PRA expects firms to reflect these risks within their internal models and considers that an approximate approach of assuming that only part of the movement in credit spreads is passed on to the IAS 19 discount rate may be acceptable in appropriate circumstances.

Superseded

1 Conditions Governing Business 3.8(2)(c) in the PRA Rulebook.
2 Solvency Capital Requirement - Internal Models 11.6 in the PRA Rulebook.
3 Paragraph 83 of IAS 19.

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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.[1] 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 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.[2] However, the PRA expects the firm 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 Deleted

1 Solvency Capital Requirement – General Provisions 3.3 and 3.4 in the PRA Rulebook.
2 Solvency Capital Requirement – Internal Model 11.8(1) in the PRA Rulebook.

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Appendix: SS5/15 updates

SS5/15[1] was originally published following CP24/14, 'Solvency II: further measures for implementation'.[2]

This appendix details the changes that were made to this SS following its initial publication.

21 November 2016

This update makes the following additions and changes:

- paragraph 1.1: sets out the firms to which this statement is addressed. It also includes specific details from the previous paragraph 1.2. The information on the legislation and other documents relevant to this statement has been moved to paragraph 1.2A;
- paragraph 1.2A: provides information on the legislation and other documents that should be considered in conjunction with this statement;
- paragraph 1.3: sets out the general purpose of this statement and how this enables the PRA to meet its statutory objectives;
- paragraphs 3.3 and 3.4: set out some additional considerations in terms of the calibration of internal models with regard to credit spread widening; and
- Chapter 6 on the cost benefit analysis (paragraph 6.1 in the previous version of this supervisory statement) has been removed as this analysis has been reviewed for Consultation Paper 20/16 which proposed changes to this SS.

Superseded

1 PRA Supervisory Statement, 'Solvency II: the treatment of pension scheme risk', March 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss515.aspx.
2 November 2014; www.bankofengland.co.uk/pra/Pages/publications/cp/2014/cp2414.aspx.