BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP16/15

Solvency II: consistency of UK generally accepted accounting principles with the Solvency II Directive

April 2015

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Responses are requested by 10 July 2015.

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1 Introduction

1.1 This paper consults on a draft supervisory statement which sets out the Prudential Regulation Authority's (PRA) expectations of firms in relation to the application of Article 9 (4) of the Commission Delegated Regulation (EU) 2015/35 ('the Solvency II Regulation').[1] This provision contains a derogation ('the derogation') which permits a firm to value some assets and liabilities using local generally accepted accounting principles (GAAP) if some very specific criteria listed in that Article are fulfilled.

Statutory obligations

1.2 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[2] and relevant provisions of the Legislative and Regulatory Reform Act 2006.

1.3 This statement expands on the PRA's general approach as set out in its Insurance Approach document.[3] By clearly and consistently explaining its views in this area, 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 The PRA[4] has also assessed whether the content of this consultation facilitates effective competition in markets for services provided by PRA-authorised persons in carrying on regulated activities. The derogation is designed to introduce the principle of proportionality into Solvency II valuation requirements and this consultation is designed to explain the PRA expectations regarding to which accounting practices the derogation applies. The PRA therefore considers the content of this consultation as compatible with the facilitation of effective competition since it is expected to reduce administrative burden.

1.5 The PRA's clarification of which UK GAAP provisions may potentially be applied for recognition and valuation purposes (if the specific criteria of the derogation are fulfilled) will reduce the administrative burden on firms which are considering whether to seek to apply the derogation and so facilitates both effective competition and consistent treatment between firms.

Impact on mutuals

1.6 This draft supervisory statement is intended to apply to all firms within the scope of Solvency II. This includes mutuals which, in the PRA's view, are unlikely to be affected any differently from other firms.

Equality and diversity

1.7 The PRA has considered the equality and diversity aspects of the content of this consultation, and is satisfied that it does not give rise to equality and diversity implications.

Cost benefit analysis

1.8 The purpose of this statement is to provide firms with clarity regarding which UK GAAP provisions the PRA considers may potentially be used for recognition and valuation purposes, if the specific criteria of the derogation are fulfilled. It is expected to reduce administrative costs for firms which are considering whether to apply the derogation. It is not expected to change own funds materially, as compared to the PRA's most recent assessment of Solvency II's impact on own funds, published in CP16/14.[5]

Responses and next steps

1.9 The PRA welcomes views on the statement by 10 July 2015 using email CP16_15@bankofengland.co.uk. In particular, respondents may wish to comment on any provisions in relation to which a more detailed analysis would be helpful.

(1) http://ec.europa.eu/finance/insurance/solvency/solvency2/index_en.htm.
(2) Section 3B of FSMA 2000.
(3) www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1304.pdf.
(4) In accordance with s.130 Financial Services (Banking Reform) Act 2013 which amends s.2H Financial Services and Markets Act 2000 (FSMA), when discharging its general functions in a way that advances its objectives (see section 2F FSMA), the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.
(5) *PRA Consultation Paper CP16/14*, 'Transposition of Solvency II: Part 3', August 2014; www.bankofengland.co.uk/pra/Pages/publications/cp/2014/cp1614a.aspx.

Appendix

Draft Supervisory Statement

Solvency II: consistency of UK generally accepted accounting principles with the Solvency II Directive

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Supervisory Statement | SSXX/15

Solvency II: consistency of UK generally accepted accounting principles with the Solvency II Directive

April 2015

1 Background

1.1 This draft supervisory statement is addressed to all insurance firms within the scope of Solvency II reporting under UK generally accepted accounting principles (GAAP) rather than using international accounting standards (IFRS).

1.2 The PRA is publishing this statement to expand on its general approach as set out in its Insurance Approach document.(1) By clearly and consistently explaining its views in this area, 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.

1.3 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.(2)

1.4 Article 9 of the Solvency II Regulation (EU) 2015/35 ('the Solvency II Regulation') contains a derogation ('the derogation') for firms within the scope of Solvency II for which annual financial statements and consolidated financial statements (if any) are prepared under UK generally accepted accounting principles. This allows them the option of recognising and valuing assets and liabilities under UK GAAP for Solvency II purposes if:

- UK GAAP is consistent with Article 75 of the Solvency II Directive;
- the valuation method is proportionate to the nature, scale, and complexity inherent in the business of the undertaking; and
- the process of valuing the assets and liabilities using international accounting standards would impose costs which are disproportionate with respect to the total administrative expenses of the firm.

1.5 The PRA expects a firm wishing to take advantage of the derogation to provide supporting evidence regarding the second and third conditions to its supervisor before so doing. However, rather than each firm having individually to consider and establish whether its proposed accounting treatment is consistent with Article 75 of the Solvency II Directive, and in order to promote consistency in application of the derogation, this supervisory statement lists those UK GAAP treatments which the PRA considers to be consistent with Article 75 of the Solvency II Directive, in full or in part.

1.6 The derogation relates to paragraphs 1 and 2 of Article 9 of the Solvency II Regulation, but does not affect the application of Articles 10 to 16 except to the extent that these provisions refer back to Article 9 regarding recognition or valuation. Therefore in addition to Article 9:

	The derogation:
Article 10: valuation hierarchy	• applies to the whole of Article 10 of the Solvency II Regulation.
Article 14: valuation methods for specific liabilities	• applies to the first sentence of Article 14 (1). The second sentence of Article 14 (1) reiterates requirement in Article 75 (1) of the Solvency II Directive, and as such cannot be derogated by the Solvency II Regulations. • does not apply to Article 14 (2).
Article 15: deferred tax	• applies to Article 15 (1), but not to Article 15 (2) or (3).

1.7 Any firm that relies on the derogation will still be expected to apply in full the remaining valuation requirements of the Solvency II Regulation, regardless of whether the UK GAAP provisions are consistent with Article 75 of the Solvency II Directive.

1.8 For insurance firms, most of the differences between UK GAAP and international accounting standards relate only to the level of detail which must be disclosed. Since the derogation addresses recognition and valuation of assets and liabilities rather than their disclosure, it is likely to have a limited effect in the United Kingdom.

(1) www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1304.pdf.
(2) http://ec.europa.eu/finance/insurance/solvency/solvency2/index_en.htm.

2 Consistency of Article 75 of the Solvency II Directive with UK GAAP to which the derogation may apply

2.1 The PRA has analysed the financial reporting standards (FRS) to consider whether these are consistent with Article 75 of the Solvency II Directive and therefore within the possible scope of the derogation. Its conclusions are set out in the table below.

2.2 Where a firm is discussing with its usual supervisor contact whether the conditions for application of the derogation apply, the PRA expects that firm to apply this supervisory statement's conclusions on FRS consistency with Article 75 of the Solvency II Directive as regards which provisions of UK GAAP it may use.

	Derogation permits use of FRS?	**Reason**
FRS100	n.a.	Provisions do not contain valuation methodologies.
FRS101	n.a.	Provisions do not contain valuation methodologies.
FRS102		
Chapters 1–10	n.a.	Provisions do not contain valuation methodologies.
Chapter 11: Basic financial instruments	Yes, with amendments	**Assets**: The fair value measurement methodology is consistent with Article 75 of the Solvency II Directive. **Liabilities**: The fair value measurement methodology is consistent with Article 75 of the Solvency II Directive when an item is initially recognised. Subsequently, the second sentence of Article 14 of the Solvency II Regulation applies; there shall be no valuation adjustment to take account of the change in own credit standing of the insurance or reinsurance undertaking.
Chapter 12: Other financial instruments	Yes, with amendments	The fair value measurement methodology is consistent with Article 75 of the Solvency II Directive when an item is initially recognised. Subsequently, the second sentence of Article 14 of the Solvency II Regulation applies; there shall be no valuation adjustment to take account of the change in own credit standing of the insurance or reinsurance undertaking.
Chapter 13: Inventories	No	Article 16 (5) of the Solvency II Regulation still applies.
Chapter 14: Investment in associates	No	Article 13 of the Solvency II Regulation still applies.
Chapter 15: Investment in joint ventures	No	Article 13 of the Solvency II Regulation still applies.
Chapter 16: Investment property	Yes, for one valuation option	Only the fair value model methodology is consistent with Article 75 of the Solvency II Directive.
Chapter 17: Property plant and equipment	Yes, for one valuation option	Only the revaluation model is consistent with Article 75 of the Solvency II Directive.
Chapter 18: Intangibles other than goodwill	No	Article 12 of the Solvency II Regulation still applies.
Chapter 19: Business combinations and Goodwill	Yes, in part	**Business combinations** — Acquisition accounting: the fair value valuation is consistent with Article 75 of the Solvency II Directive. **Goodwill** — Article 12 of the Solvency II Regulation still applies.
Chapter 20: Leases	No	Article 16 (4) of the Solvency II Regulation still applies.
Chapter 21: Provisions and contingencies	No	**Provisions and contingent assets** — provisions consistent with IFRS valuation methodology so using IFRS would not impose disproportionate costs. **Contingent liabilities** — Article 11 of the Solvency II Regulation still applies.

	Derogation permits use of FRS?	Reason
Chapter 22: Liabilities and equity	No	Solvency II regulatory capital is not dependent on accounting treatment.
Chapter 23: Revenue recognition	n.a.	Provisions do not contain valuation methodologies.
Chapter 24: Government grants	Yes	Both the recognition and fair value measurement are consistent with Article 75 of the Solvency II Directive.
Chapter 25: Borrowing costs	No	Provisions are based on a cost model so are not consistent with Article 75 of the Solvency II Directive.
Chapter 26: Share based payments	Yes	This fair value valuation methodology is consistent with Article 75 of the Solvency II Directive.
Chapter 27: Impairment of assets	No	Provisions are based on a cost model so are not consistent with Article 75 of the Solvency II Directive.
Chapter 28: Employee benefits	Yes	The measurement principles for employee benefits are consistent.
Chapter 29: Income tax	No	**Tax** — provisions consistent with IFRS valuation methodology so using IFRS would not impose disproportionate costs. **Deferred tax** — Provisions are consistent with IFRS as regards Article 15(1) of the Solvency II Regulation so using IFRS would not impose disproportionate costs. Article 15(2) and (3) of the Solvency II Regulation still applies.
Chapter 30: Foreign currency translation	No	Provisions consistent with IFRS valuation methodology so using IFRS would not impose disproportionate costs.
Chapter 31: Hyperinflation	Yes	The figures of current and corresponding prior periods are restated in terms of the measuring unit current at the end of the reporting period, which is consistent with Article 75 of the Solvency II Directive.
Chapters 32–33	n.a.	Provisions do not contain valuation methodologies.
Chapter 34: Specialist activities		
Agriculture	Yes, (in part)	Fair value less cost to sell is consistent with Article 75 of the Solvency II Directive where estimated cost to sell is immaterial. If costs to sell are material, then the adjustment required by Article 16 (7) of the Solvency II Regulations should be applied.
Extraction activities	n.a.	PRA does not expect these provisions to apply to insurance undertakings.
Service concession arrangements	n.a.	PRA does not expect these provisions to apply to insurance undertakings.
Financial Institutions	n.a.	Provisions do not contain valuation methodologies.
Retirement benefit plans	n.a.	PRA does not expect these provisions to apply to insurance undertakings.
Heritage assets	n.a.	PRA does not expect these provisions to apply to insurance undertakings.
Funding commitments	In part, with amendments	**Liabilities** — Where the funding commitment is a liability the fair value measurement methodology is consistent with Article 75 of the Solvency II Directive at the point the funding commitment is initially recognised. Subsequently, there shall be no valuation adjustment to take account of the change in own credit standing of the insurance or reinsurance undertaking. **Contingent liabilities** — Where the funding commitment is a contingent liability Article 11 of the Solvency II Regulation still applies.

	Derogation permits use of FRS?	**Reason**
Income resources from non-exchange transactions	Yes	The fair value valuation basis is consistent with Article 75 of the Solvency II Directive.
Public benefit entity combinations	n.a.	PRA does not expect these provisions to apply to insurance undertakings.
Public benefit entity concessionary loans	n.a.	PRA does not expect these provisions to apply to insurance undertakings.
Chapter 35	No	This chapter provides transitional provisions from the previous UK GAAP regime.
FRS 103	No	Articles 76 to 86 of the Solvency II Directive and Chapter III of the Regulation still apply.