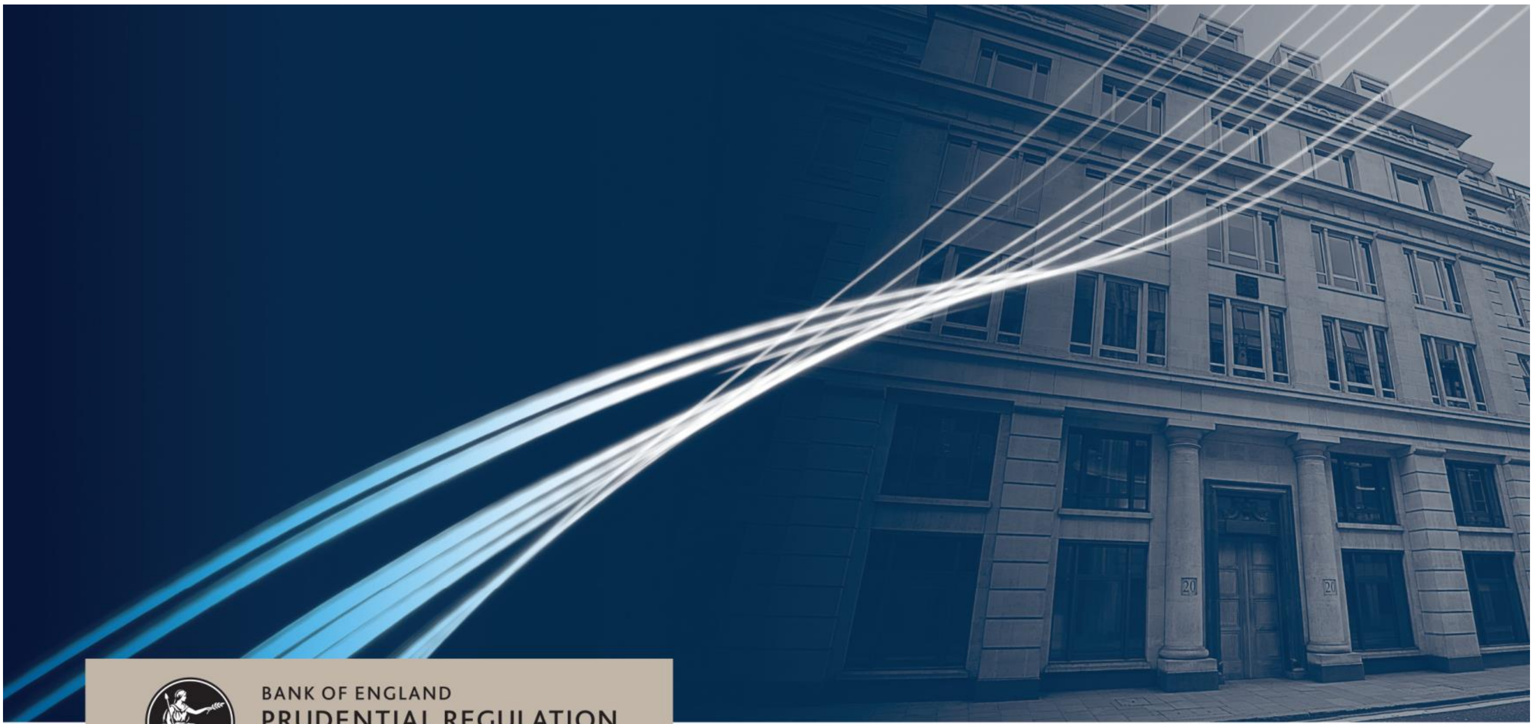

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP11/19

Solvency II: Maintenance of the transitional measure on technical provisions

May 2019

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The response will be assessed to inform our work as a regulator and central bank, both in the public interest and in the exercise of our official authority. We may use your details to contact you to clarify any aspects of your response.

The consultation paper will explain if responses will be shared with other organisations (for example, the Financial Conduct Authority). If this is the case, the other organisation will also review the responses and may also contact you to clarify aspects of your response. We will retain all responses for the period that is relevant to supporting ongoing regulatory policy developments and reviews. However, all personal data will be redacted from the responses within five years of receipt. To find out more about how we deal with your personal data, your rights or to get in touch please visit bankofengland.co.uk/legal/privacy.

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Responses are requested by Wednesday 21 August 2019.

Please address any comments or enquiries to:
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

Email: CP11_19@bankofengland.co.uk

Contents

1 Overview

1.1 This consultation paper (CP) sets out the Prudential Regulation Authority's (PRA) proposals to update Supervisory Statement SS6/16 'Maintenance of the 'transitional measure on technical provisions' under Solvency II'.[1]

1.2 The proposals are aimed at:

- providing additional guidance for firms proposing to use a proportionate approach to the transitional measure on technical provisions (TMTP) recalculation methodology; and
- providing further clarity on the consistency of Solvency I and Solvency II methodologies.

1.3 The CP is relevant to: UK insurance and reinsurance firms within the scope of Solvency II that have been granted approval to use the TMTP; the Society of Lloyds; and firms that are considering applying to use this transitional measure.

1.4 The proposed updates to SS6/16 (appendix) should be read in conjunction with

- the Transitional Measures Part of the PRA Rulebook; [2]
- the Solvency 2 Regulations 2015 (2015/575);[3]
- the Solvency II Directive (Article 308(d));[4]
- the European Insurance and Occupational Pension Authority (EIOPA) Level 3 Guidelines;[5] and
- SS17/15 'Solvency II: transitional measures on risk-free interest rates and technical provisions'.[6]

Background

1.5 The Solvency II Directive allows firms to apply to their supervisory authority for approval to use the TMTP. The TMTP mitigates changes to the calculation of technical provisions (TP) which have been introduced by Solvency II. The starting point for the calculation of the TMTP is a comparison of TP calculated under Solvency I Pillar 2 (Individual Capital Adequacy Standards) and under Solvency II. At the end of 2016, the TMTP contributed ca. £33 billion to firms' balance sheets in total (year-end 2017 approx. £31 billion), of which around 80% related to the risk margin.

1.6 In its response to the Treasury Select Committee's (TSC) report on Solvency II, the PRA recognised the burden of maintaining multiple systems for recalculation of the TMTP and committed to considering the feasibility of simplifying the TMTP calculations.[7] In recognising that the current

1 The current version, published on 28 April 2017, is available at https://www.bankofengland.co.uk/prudential-regulation/publication/2016/maintenance-of-the-transitional-measure-on-technical-provisions-under-solvency2-ss.
2 http://www.prarulebook.co.uk/
3 http://www.legislation.gov.uk/uksi/2015/575/pdfs/uksi_20150575_en.pdf
4 http://data.europa.eu/eli/dir/2009/138/2014-05-23
5 https://eiopa.europa.eu/GuidelinesSII/EIOPA_EN_LTG_GLs.pdf
6 The current version, published on 25 November 2016, is available at https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-transitional-measures-on-risk-free-interest-rates-and-technical-provisions-ss.
7 'PRA response to the Treasury Committee's inquiry into Solvency II', February 2018; https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-response-to-the-treasury-committees-inquiry-into-solvency-2. See also news release 'PRA launches a series of improvements to the implementation of Solvency II', October 2017; https://www.bankofengland.co.uk/news/2017/october/pra-launches-series-of-improvements-to-the-implementation-of-solvency-ii.

operation of the TMTP is overly burdensome for firms, the PRA has investigated a range of methodologies to simplify the TMTP recalculations.

1.7 Furthermore, following responses to CP13/18 'Solvency II: Equity release mortgages', and subsequent publication of the final policy in PS31/18 'Solvency II: Equity release mortgages',[8] the PRA has considered the approach to consistency between Solvency I and Solvency II bases set out in SS6/16.

1.8 The PRA's proposals for simplifying the TMTP calculation are set out in Chapter 2, as well as proposals to align the Solvency I and Solvency II approach to that calculation.

Responses and next steps

1.9 This consultation closes on Wednesday 21 August 2019. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP11_19@bankofengland.co.uk.

1.10 The proposals set out in this CP have been designed in the context of the current UK and EU regulatory framework. The PRA has assessed that the proposals will not be affected in the event that the UK leaves the EU with no implementation period in place.

2 Proposals

Use of simplified methods to recalculate the TMTP

2.1 The principles that the PRA applied when considering methodologies were that any simplification method:

- must be consistent with the Solvency II Directive (Article 308(d)) as transposed into UK law under the Solvency 2 Regulations 2015 (2015/575); and
- should not result in the material overstatement of the amount of TMTP claimed that clearly results in condition 1[9] ceasing to be met.

2.2 The PRA has concluded that a unified simplification approach across all firms is unlikely to be feasible, and that a firm-specific approach is needed to cater for the particular circumstances of different firms and the range of specific situations that result in recalculation of the TMTP. In reaching its conclusion, the PRA has considered information published by the Institute and Faculty of Actuaries (IFoA) and firms through the Association of British Insurers (ABI).

2.3 The PRA proposes that firms could develop their own simplification methods, and discuss with their supervisors ahead of the expected recalculation at 31 December 2019.

2.4 The PRA also proposes that firms would be expected to be able to demonstrate to the PRA that the simplified methodology results in a TMTP that is in line with that calculated under Regulation 54 of the Solvency 2 Regulations 2015 (2015/575). Firms using a simplified method would be expected to have carried out sufficient validation and back-testing to show that the simplified method does not introduce material distortion into the amount of TMTP. The PRA expects that firms will be able

8 Published in July and December 2018 respectively, both publications are available at https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages.

9 Regulation 54 of the Solvency 2 Regulations 2015 (2015/575) sets out that the amount of TMTP should not exceed that calculated according to the formula in table 3 (set out in the Regulations) describing the meaning of condition 1.

to justify further simplifications as the materiality of the TMTP reduces over the remaining transitional period.

2.5 The draft amendments to SS6/16 set out some example simplification approaches firms may wish to consider. The PRA is open to including other suggestions for simplification methods which have general applicability and where firms can demonstrate that they meet the expectations set out in paragraphs 4.18B to 4.18E of the draft SS.

Consistency of Solvency I and Solvency II bases

2.6 Following responses to CP13/18 and the publication of the final policy in PS31/18, the PRA has considered the approach to consistency between Solvency I and Solvency II bases set out in SS6/16. The PRA proposes that the Solvency I Pillar 2 component of the TMTP calculation (and Pillar 1 for the financial resources requirement (FRR) test if relevant) should use the same methodology as at 31 December 2015 (together with any specific changes that the firm has previously agreed with the PRA). There should, with limited exception, be no further retrospective change to the Solvency I methodology. The firm's best estimate assumptions used in the TMTP calculation should continue to update based on up-to-date and credible information and reflect operating conditions and changes to the firm's risk profile.

2.7 The PRA also proposes to update SS6/16 with guidance for firms regarding how the Solvency I basis should be calculated to allow for the inclusion of assets containing new risks (backing the business written prior to 2016) for which a specific INSPRU 7 methodology was not in force at 31 December 2015[10].

3 The PRA's statutory obligations

3.1 The PRA is required by the Financial Services and Markets Act 2000 (FSMA)[11] to consult when setting its general policies and practices. In doing so, it is required to comply with several statutory and public law obligations. The PRA meets these obligations by providing the following in its consultations:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed rules is compatible with the PRA's duty to act in a way that advances its general objective,[12] insurance objective[13] (if applicable), and secondary competition objective;[14]
- an explanation of the PRA's reasons for believing that making the proposed rules are compatible with its duty to have regard to the regulatory principles;[15] and

10 See Chapter 7 of the INSPRU Prudential Sourcebook of Insurers Part of the PRA Rulebook at 31 December 2015: http://www.prarulebook.co.uk/rulebook/Content/Chapter/277732/31-12-2015
11 Section 138J of FSMA.
12 Section 2B of FSMA.
13 Section 2C of FSMA.
14 Section 2H(1) of FSMA.
15 Sections 2H(2) and 3B of FSMA.

- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons.[16]

3.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[17]

3.3 The PRA is also required by the Equality Act 2010[18] to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.4 The PRA has considered the impact of the proposals in the draft supervisory statement on firms and the PRA. The PRA believes that the proposals in the statement are compatible with its duty to use its resources effectively and does not expect the proposals in this statement to give rise to significant costs for firms. It is expected that simplifications in the TMTP calculation will lead to lower annual costs for both firms and the PRA, without reducing prudential standards.

Compatibility with the PRA's objectives

3.5 The PRA considers that the proposals set out in the CP are compatible with the PRA's statutory objectives under the Financial Services and Markets Act 2000 (FSMA). The proposals are consistent with the PRA's general objective to promote safety and soundness of the firms and the PRA's insurance specific objective to contribute to the securing of an appropriate degree of protection for those who may become insurance policyholders, by ensuring that the appropriate amount of transitional relief is applied in the calculation of technical provisions and valuation of own funds.

3.6 The PRA also has a duty to facilitate effective competition as a secondary objective subordinate to its general safety and soundness and its policyholder protection objectives.[19] The PRA considers that the proposals may facilitate effective competition through recognising that firms may adopt methods to simplify the TMTP calculation which are commensurate with their individual circumstances. Furthermore, the PRA is not requiring firms to adopt simplified methods for calculating the TMTP if it is not appropriate to do so.

Regulatory principles

3.7 In developing the proposals in this CP, the PRA has had regard to the regulatory principles[20]. Three of the principles are of particular relevance.

3.8 The principle that a burden or restriction which is imposed on a person should be proportionate to the benefits, which are expected to result from the imposition of that burden. The PRA has followed this principle when developing the proposals outlined in this CP, and considers that the ability for firms to adopt simplified approaches to calculating the TMTP that can reduce the burden to firms is consistent with taking a proportionate approach.

3.9 The desirability of the PRA exercising its functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons. The PRA considers that the proposals in this CP recognise the differences between individual firms and that a unified approach

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16 Section 138K of FSMA.
17 Section 30B of the Bank of England Act 1998.
18 Section 149.
19 Section 2H(1) of FSMA
20 Section 3B of FSMA

toward simplifying the TMTP calculation is unlikely to be appropriate. The PRA has tried to balance the need to simplify the calculation with the need to maintain security of policyholder benefits.

3.10 The principle that the PRA should exercise its functions as transparently as possible. The proposals contained in this CP build on the 2016 supervisory statement SS6/16 and the update published in April 2017.

Impact on mutuals

3.11 The PRA considers that the impact of the proposals on mutual is expected to be no different from the impact on other firms.

HM Treasury recommendation letter

3.12 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.[21]

3.13 The aspect of the Government's economic policy most relevant to the proposals in this CP is competition.

3.14 This aspect has been considered in the 'compatibility with the PRA's objectives' and 'regulatory principles' sections above.

Equality and diversity

3.15 The PRA considers that the proposals do not give rise to equality and diversity implications.

21 Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at http://www.bankofengland.co.uk/about/people/prudential-regulation-committee.

Appendix: Draft amendments to SS6/16

This appendix proposes changes to Supervisory Statement 6/16 'Maintenance of the 'transitional measure on technical provisions' under Solvency II'. Underlining indicates proposed additions and striking through indicates proposed deletions.

…

3 Consistency of the Solvency I and Solvency II bases

…

3.2 Firms are expected to review the best estimate assumptions ~~and methodologies~~ at regular intervals, and when it is appropriate, to make changes that reflect changes in operating experience and the firm's risk profile.

3.3A In calculating Solvency I technical provisions for the purpose of the TMTP, firms should apply the methodologies that they were using as at 31 December 2015. The PRA does not expect firms to make any further retrospective changes to these Solvency I methodologies (apart from specific changes that the firm has previously discussed and agreed with the PRA). However, a firm should discuss with its usual supervisory contact any query regarding how the Solvency I basis should be calculated to allow for post 31 December 2015 changes which could impact the TMTP calculation, for example investment in new asset classes, implementation of with-profits estate distribution or management actions in respect of business written before the introduction of Solvency II. The PRA expects the Solvency I approach to the evaluation of new risks to be identical to the Solvency II basis for the purposes of the TMTP calculation unless the firm can sufficiently demonstrate that the risk was addressed in a different way in methodologies used as at 31 December 2015.

…

4 Recalculations of the transitional measure

…

4.18 The PRA recognises that a proportionate approach in the calculation of the TMTP may involve the use of estimates, for example those used for firms' solvency monitoring processes. The methodology used to calculate the TMTP, in particular where this relies on simplifying approximations, should be clearly documented. ~~The use of less precise methodologies should not result in the material overstatement of the amount of TMTP claimed (ie condition 1 ceases to be met) and should not introduce material distortion into the evaluation of a firm's own funds and hence solvency position.~~

4.18A The PRA considers that it is unlikely that a single generic approach will be suitable to simplify the calculation for all firms. Instead the PRA expects that firms will consider whether and what simplifications are appropriate for their own use, taking into consideration their own balance sheet structure and business mix.

4.18B Firms should discuss any simplification methods that they intend to use for recalculating the TMTP with their supervisors. In developing a simplified approach firms should ensure that the proposed method does not lead to a material overstatement of the amount of TMTP claimed (ie clearly resulting in condition 1 of Regulation 54 of the Solvency 2 Regulations 2015 (2015/575) ceasing to be met).

4.18C In addition to firms' proposed approaches, some of the approaches that the PRA considers may be useful for firms to consider are:

- identifying the main drivers of the results of the calculation of the TMTP deduction in condition 1 of Regulation 54 of the Solvency 2 Regulations 2015 (2015/575) (before condition 3 is applied) and focus on recalculation of those components when performing the calculation. In some cases firms may be able to use a similar method for the application of any limit to the TMTP; and

- removing or simplifying the FRR test calculation for the non-biting Pillar of Solvency I if one Pillar is significantly in excess of the other, and there is justification or analysis demonstrating that this will continue being the case under different market conditions and circumstances.

4.18D The PRA expects firms using a simplified methodology for recalculation to demonstrate that they are able to apply a deduction that is not materially different to that calculated as per the requirement of Regulation 54 of the Solvency 2 Regulations 2015 (2015/575). This may include validation and back-testing that the method does not introduce material distortion to the amount of TMTP.

~~4.18~~ 4.18E Firms will also need to differentiate between assets and liabilities applicable to business written before and after the introduction of Solvency II. The PRA expects only the former to be included in the TMTP recalculation. The PRA expects firms to take a pragmatic approach in identifying the components of the balance sheet which are within the scope of the TMTP calculation. In some cases it may be necessary to make assumptions as to how to do this, for example whether assets should be hypothecated between cohorts of the business written before and after the introduction of the Solvency II regime.

…