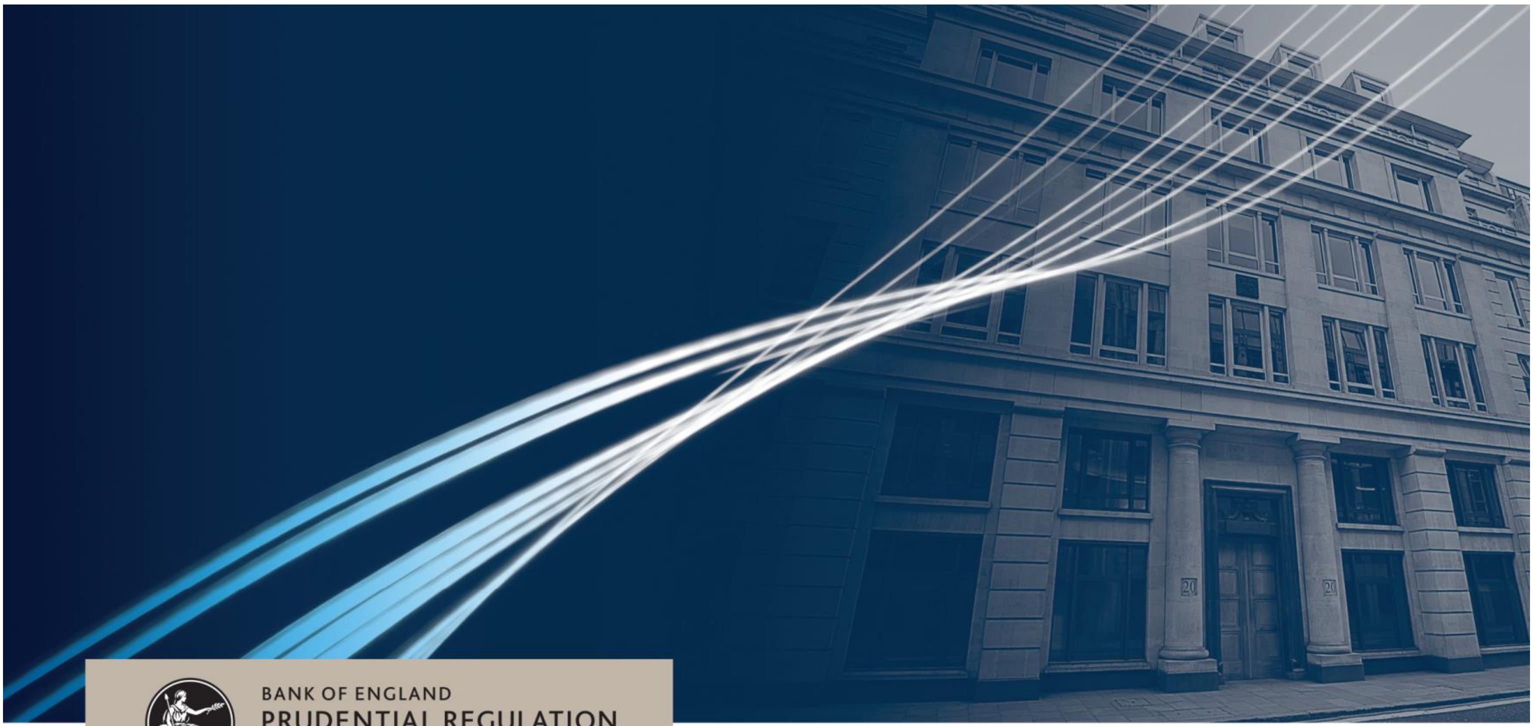

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP3/19

Solvency II: Longevity risk transfers - simplification of pre-notification expectations

February 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 Monday 6 May 2019.

Please address any comments or enquiries to:

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1 Overview

1.1 In this Consultation Paper (CP), the Prudential Regulation Authority (PRA) sets out its proposals to update Supervisory Statement (SS) 18/16 'Solvency II: longevity risk transfers'. It proposes to change its expectations for pre-notification of longevity risk transfers and hedge arrangements, and update the key risks the PRA considers arise from longevity risk transfers.

1.2 The proposed change would reduce the expectations for pre-notification of some new longevity risk transfers, with the intention of simplifying the process and maintaining proportionality in the PRA's supervision.

1.3 This CP is relevant to PRA-authorised UK firms that fall within the scope of the Solvency II Directive and to the Society of Lloyd's.

1.4 The PRA has completed a number of deep dive reviews into firms' understanding and management of the risks arising from carrying out longevity risk transfers. In light of these reviews, the PRA has identified an opportunity to reduce the reporting burden firms have under the current expectations. The PRA proposes to simplify and reduce the amount of time and effort firms are expected to spend on pre-notification for transactions that would not be considered large or complex enough to warrant additional engagement.

Responses and next steps

1.5 This consultation closes on Monday 6 May 2019. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP3_19@bankofengland.co.uk.

1.6 The proposals in this CP have been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising once any new arrangements with the EU take effect.

2 Proposals

2.1 The PRA proposes to update SS18/16 (see Appendix), to change its expectations for how firms notify the PRA of new longevity risk transfer arrangements; and to highlight an additional key risk (basis risk) which should be included in firms' assessments of the residual risks these transactions give rise to.

2.2 The proposed changes differentiate between the level of pre-notification expected for large and/or complex transactions, and other transactions. For large and/or complex transactions, which are defined in the updated SS, the PRA does not propose to change how firms engage with the PRA in advance of their execution. However, for other transactions, the PRA proposes to streamline the notification process by enabling firms to report these via a template. In addition to simplifying and standardising the information firms are required to provide to the PRA, this will also remove the need for the information to be reviewed by the PRA in advance.

3 The PRA's statutory obligations

3.1 In carrying out its policy making functions, the PRA is required to comply with several legal obligations.

3.2 The PRA is required by the Financial Services and Markets Act 2000 (FSMA)[1] 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,[2] insurance objective (if applicable),[3] and secondary competition objective;[4]
- 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;[5] and
- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons.

3.3 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[6]

3.4 The PRA is also required by the Equality Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.[7]

Cost benefit analysis

3.5 The proposal to reduce the need for early engagement and information submission to the PRA for transactions that are neither large nor complex will lead to a reduction in cost for both firms and the regulator. While a reduction in advanced engagement on some transactions could pose some risk, this risk will be mitigated by the expected lower impact of these transactions, as well as the PRA's ability to explore transactions reported via the proposed template in more detail if the PRA judges it necessary on a case by case basis.

3.6 Under the existing risk management requirements, any appropriate risk assessment should, among others, include the basis risk between the terms of the annuity contract and those of the risk transfer. Therefore, the proposal to highlight that the basis risk should be included in firms' assessments should not lead to additional costs.

Compatibility with the PRA's objectives

3.7 The proposals are intended to give firms a clear understanding of our expectations with regards to a specific element of risk management in order to promote safety and soundness of

1 Section 2L of FSMA.
2 Section 2B of FSMA.
3 Section 2C of FSMA.
4 Section 2H(1) of FSMA.
5 Sections 2H(2) and 3B of FSMA.
6 Section 30B of the Bank of England Act 1998.
7 Section 149.

UK firms. In particular, it seeks to ensure that the residual risks taken on by firms seeking longevity risk transfer(s), which are often offshored outside the PRA's jurisdiction, do not undermine the industry's safety and soundness.

3.8 The PRA has assessed whether the proposal in this CP facilitates effective competition. The proposal to highlight the need to include basis risk in firms' risk assessment helps to ensure appropriate risk identification and management, which helps to facilitate effective competition. The proposal to streamline the notification process for transactions that are neither large nor complex should help to facilitate effective competition as it facilitates the growth of smaller firms and the entry of new players as their transactions are more likely to be neither large nor complex.

Regulatory principles

3.9 In developing the proposals in this CP, the PRA has had regard to the regulatory principles as set out in FSMA. The PRA considers the draft changes to the SS to be compatible with the regulatory principles. Two principles are of particular relevance:

(i) The need to be proportionate – the proposed changes aim to gather only detailed information in advance for transactions that are more likely to pose the greatest risk to the PRA's objectives.

(ii) The need to use the resources of each regulator in the most efficient and economic way – the proposed changes aim to reduce the volume of data reported by firms to the PRA; reducing the need for data collection, maintenance, and analysis on the part of the PRA.

Impact on mutuals

3.10 The PRA considers that the impact of the proposed rule changes on mutuals is expected to be no different from the impact on other firms.

HM Treasury recommendation letter

3.11 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.[1]

3.12 The aspects of the Government's economic policy most relevant to the proposals in this CP are 'competition', which has been considered in paragraph 3.8 and 'better outcomes for consumers' which has been considered in paragraph 3.7.

3.13 The PRA's proposal on longevity risk transfer seeks to ensure that risks are being appropriately managed while at the same time not leading to barriers to entry or growth for firms whose business models are reliant on transferring certain risks such as longevity off their balance sheet.

3.14 The risks at the focus of the SS are not captured by the capital regime. Therefore prudent risk management outside the capital regime is necessary to ensure an appropriate degree of protection for the ultimate consumers and policyholders.

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

Equality and diversity

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

Appendix: Draft amendments to Supervisory Statement 18/16 'Solvency II: longevity risk transfers'

In this appendix deleted text is struck through and new text is underlined.

…

2 Risks associated with longevity risk mitigation measures

…

2.3 An additional risk that could be introduced by longevity risk transfers is basis risk between the terms of the annuity contract and those of the risk transfer. The PRA expects firms to include their appetite for basis risk within their risk management frameworks.

3 Notification

3.1 In order to supervise firms' risk management practices, the PRA expects to be notified of new large and/or complex longevity risk transfer and hedge arrangements, and the firm's proposed approach to risk management well in advance of the completion of any transaction. This expectation applies where a firm is buying or selling longevity protection. The definition of what constitutes a large and/or complex transaction would be those that:

- have a value/financial impact that are larger than typically transacted on a business as usual basis;
- have a structure that is more complex than business as usual transactions (for example, where the risk transfer is structured using instruments less tested in the market such as insurance linked securities, or by the firm, such as automatic reinsurance pools); or
- have a material incremental impact on the firm's ability to meet its Solvency Capital Requirements under Solvency II.

3.2 For all other longevity risk transfers, we have sought to reduce the pre-notification requirements in a way that reduces the level of detail needed and the amount of time firms spend compiling this information.

3.3 For these other transactions, firms should update the PRA of the transaction details by completing the template in the Appendix to this Supervisory Statement and returning it to their supervisory contact. This template may be submitted shortly after the reinsurance has been placed.

3.4 As well as allowing the PRA to gain a fuller picture of the market in a way that requires less time and effort on the part of firms, this template would also allow it to understand the potential build-up of risk concentrations as a result of these transactions. This will enable supervisors to consider whether the risks of the proposed transaction are being appropriately managed and that the transaction has an underpinning rationale that is consistent with good risk management principles.

Appendix – transaction reporting template

Counterparty name and location	Existing counterparty (Y/N)	Intragroup transaction (Y/N)	Longevity swap or quota share?	Effective date
Notional liability amount transferred (£M)	Notional liability covered by collateral (£M)	Collateral mechanism	Eligible collateral assets	Any additional features of note (eg pre-Part VII reinsurance, whether it is covered by TMTP)