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Consultation Paper | CP1/21

Solvency II: Deep, liquid and transparent assessments, and GBP transition to SONIA

January 2021

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Responses are requested by Wednesday 31st March 2021.

In light of current measures to help prevent the spread of COVID-19, please address any comments or enquiries by email to: CP01_21@bankofengland.co.uk.

Alternatively, please address any comments or enquiries to:
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Contents

1 Overview

1.1 This Consultation Paper (CP) sets out the Prudential Regulation Authority's (PRA's) proposed approach to deep, liquid and transparent (DLT) assessments and the transition of Solvency II technical information (TI) from the London Interbank Offered Rate (Libor) to the Sterling Overnight Index Average (SONIA) in 2021.

1.2 The proposals in this CP would result in changes to the PRA Statement of Policy (SoP) 'The PRA's approach to the publication of Solvency II technical information' (Appendix).[1]

1.3 This CP is relevant to all UK Solvency II firms, including in respect of the Solvency II groups provisions, and to the Society of Lloyd's and its managing agents (hereafter referred to as UK insurers). Non-Directive firms are out of the scope of this CP.

1.4 From 11pm on Thursday 31 December 2020, the PRA is required to publish technical Information (TI) for each relevant currency.[2] The TI includes the basic risk-free rates (RFRs) and fundamental spreads used in the calculation of the matching adjustment (MA) and volatility adjustment. The RFRs must be based on financial instruments traded in a deep, liquid and transparent financial market.[3] From Thursday 31 December 2020 and throughout 2021, the PRA's relevant currencies are: GBP, USD, EUR, CAD, SEK, AUD, JPY, NOK, and DKK.

1.5 The Solvency II TI for GBP, USD, and JPY currently reference Libor rates. In December 2020, the administrator of Libor, ICE Benchmark Administration, published a consultation on its intention for the GBP, JPY, and some USD Libor panels to cease at end-2021, and for the remainder of USD panels to cease at end-June 2023.[4] The Working Group on Sterling Risk-Free Reference Rates (RFRWG) recommended that the Sterling Overnight Index Average (SONIA) is used as the preferred replacement for Libor for sterling markets.[5] The PRA will therefore transition the GBP Solvency II TI to reference SONIA swap rates before end-2021.

1.6 The PRA will also transition the JPY and USD TI references from Libor to an Overnight Indexed Swap (OIS) rate although the date and approach to these transitions will depend on the liquidity of swaps referencing the Tokyo Overnight Average Rate (TONA) and the Secured Overnight Financing Rate (SOFR). The transition of Solvency II TI references from Libor to OIS rates is also discussed in HM Treasury's Call for Evidence for the Review of Solvency II.[6]

1.7 The GBP Libor-based rates are currently higher than the equivalent SONIA-based rates, and should this continue to be the case at the time of the proposed transition, this would generally result in an increase in technical provisions. This is in part mitigated by several proposals included in this CP, notably the proposals on transitional relief and the calculation of the long-term average spread (LTAS).

1 December 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/the-pras-approach-to-publication-of-sII-technical-information.
2 Paragraph 4B of the Solvency 2 Regulations.
3 Article 43 of the onshored Solvency II Delegated Regulation.
4 https://www.theice.com/publicdocs/ICE_LIBOR_Consultation_on_Potential_Cessation.pdf.
5 https://www.bankofengland.co.uk/news/2017/april/sonia-recommended-as-the-sterling-near-risk-free-interest-rate-benchmark.
6 Available at: https://www.gov.uk/government/publications/solvency-ii-review-call-for-evidence (Chapter 11).

Summary of proposals

1.8 The proposals in this CP cover:

(a) the PRA's proposed approach to the deep, liquid and transparent (DLT) assessment process for all relevant currencies;

(b) the transition of the GBP RFR and associated TI from Libor to SONIA and transition timetable for other Libor currencies;

(c) the determination of the credit risk adjustment (CRA) for SONIA TI, and the proposal that given the characteristics of the SONIA rates, the residual credit risk is considered to be negligible;

(d) how the calculation of the long term average spread (LTAS) would reflect the transition to SONIA;

(e) the impact on the transitional measure for technical provisions for business written before 2016; and

(f) the impact of the transition on firms with approval to apply the MA and internal models.

Implementation

1.9 The PRA proposes to implement the transition for GBP TI to SONIA from and including Saturday 31 July 2021.

Responses and next steps

1.10 This consultation closes on Wednesday 31 March 2021. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP01_21@bankofengland.co.uk.

1.11 The proposals set out in this CP have been designed in the context of the UK having left the European Union and the transition period having come to an end. Unless otherwise stated, any references to EU or EU derived legislation refer to the version of that legislation which forms part of retained EU law.[7] The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework.

7 For further information, please see https://www.bankofengland.co.uk/eu-withdrawal/transitioning-to-post-exit-rules-and-standards.

2 Proposals

2.1 This chapter sets out the PRA proposals regarding:

(a) the DLT assessment process;

(b) transition from Libor to OIS rates;

(c) the proposed approach to the determination of the CRA;

(d) how the calculation of the LTAS would reflect the transition to SONIA;.

(e) the impact on transitional measures for business written before 2016; and

(f) the impact of the transition on firms with approval to apply the MA and internal models.

Assessment of the depth, liquidity, and transparency of the market

Background and DLT assessments applicable from 31 December 2020

2.2 The onshored Solvency II Delegated Regulation (DR) requires that the rates of the risk-free interest rate term structure must be reliably determined based on financial instruments traded in a deep, liquid and transparent financial market.[8] The last liquid points for currencies are derived on the basis of a DLT assessment, which analyses whether the maturities of the reference instruments can be derived from deep, liquid and transparent markets.

2.3 The SoP stated that, 'The PRA has retained the methodologies and judgements that the European Insurance and Occupational Pensions Authority (EIOPA) incorporates in its TI as at the end of the transition period'. On Sunday 16 December 2020, EIOPA confirmed the tenors of interest rate swaps and last liquid points to be used for the derivation of the RFRs in 2021 followings its DLT assessments.[9] The PRA proposes to maintain this assessment in 2021, and will publish updated DLT assessments on an annual basis to be applied in future years. However, the PRA will also update a DLT assessment (outside the annual update) when a Libor-based RFR transitions to an OIS-based RFR.

The proposed general assessment approach

2.4 The PRA will adopt EIOPA's main initial indicators for assessing the depth and liquidity of the swaps market for all of the PRA's relevant currencies.[10] These indicators comprise the:

- average (over one year) daily notional turnover of at least €50 million; and
- average (over one year) daily number of trades of at least ten.

The PRA proposes, however, that the first of these indicators is calibrated with reference to GBP rather than EUR. In other words, it proposes a turnover volume indicator of an average daily turnover of at least £45 million.

8 Article 43.
9 https://www.eiopa.europa.eu/content/eiopa-updates-technical-documentation-results-of-deep-liquid-and-transparent-dlt-assessment_en.
10 From Thursday 31 December 2020 and throughout 2021, the currencies are: GBP, USD, EUR, USD, CAD, SEK, AUD, JPY, NOK, and DKK.

2.5 EIOPA currently adopts conditions that a previously liquid market needs to drop at least 20% below one of the thresholds to be considered illiquid, and a previously illiquid market must meet both thresholds and rise to at least 20% above one of the thresholds to be considered liquid. The PRA proposes to be guided by these as soft thresholds which may need to be adapted to reflect specific circumstances of individual markets.

2.6 The PRA may also consider other data and metrics in order to supplement its DLT assessment as required for the relevant currencies. For non-GBP currencies, the PRA proposes to make use of externally published DLT analyses, including those published by EIOPA and the International Association of Insurance Supervisors, to contribute to its own assessment. The PRA will publish the results of its DLT assessments (mentioned in paragraph 2.3 above), including how these thresholds have been applied and which other supplementary metrics and external analyses have been considered.

2.7 The PRA notes that EIOPA currently carries out a supplementary DLT assessment of corporate and government bonds for the relevant currencies. The PRA further notes that these bonds DLT assessments are in practice only relied upon when a relevant jurisdiction does not have an active swap market.[11] For all of the relevant currencies for which the PRA proposes to publish TI (at least for the first relevant period), there is an active swap market. The PRA therefore initially proposes to limit its DLT assessment to the swaps market. Should the PRA's relevant currencies in future extend to include currencies of other jurisdictions which do not have an active swap market, the PRA may consult on updating its proposed approach.

2.8 A granular country level DLT assessment is required to determine the aggregated composition of the reference portfolio for determining the EUR volatility adjustment (VA). The PRA proposes to make use of the EIOPA assessment for this more granular requirement, and would consider amendments as necessary.

The proposed DLT assessment for GBP SONIA swaps

2.9 The PRA proposes to carry out a DLT assessment for GBP SONIA swaps market data in the first half of 2021, ahead of the planned transition of the RFR to SONIA (discussed below in paragraph 2.10). This DLT assessment would apply the criteria proposed above. However, in the context of the particular circumstances of the transition from Libor to SONIA, the PRA proposes that this assessment may need to be supplemented with other relevant data and the use of expert judgment. The PRA would publish the results and analysis of its DLT assessment ahead of the transition date, including how any supplementary data and expert judgement has been applied.

Transition from Libor to Overnight Indexed Swap (OIS) rates

Timetable for transition for GBP, JPY, and USD

2.10 As mentioned in paragraph 1.5, the Solvency II TI for GBP, USD, and JPY are currently derived from Libor rates. To aid the transition from Libor, the PRA proposes to calculate the GBP RFR using SONIA for TI published with a reference date from and including Saturday 31 July 2021. The PRA will confirm the proposed transition date in the Policy Statement following consideration of any responses to this CP and the outcome of the SONIA DLT assessment proposed in paragraph 2.9 above.

11 For EUR the bonds assessment is also used to apply matching criteria, and to determine composition of VA reference portfolio.

2.11 The PRA proposes to publish indicative SONIA-based TI for GBP ahead of the transition date, and following publication of the final policy resulting from this consultation. The PRA considers that the indicative TI would assist firms in quantifying the expected balance sheet impacts arising from the PRA's transition to SONIA-based TI.

2.12 The PRA considers that adopting a methodology for calculating the RFR that combines both Libor and SONIA rates (a 'blended' approach) would not be practical in implementing the transition. As publication of GBP Libor rates is planned to cease at the end of 2021, the PRA expects liquidity in Libor swaps to decrease significantly over the year. Hence in the later months of 2021, there is expected to be insufficient liquidity in Libor markets to satisfy the criteria of the DLT assessment and therefore for rates used in a blended approach to be sufficiently reliable.

2.13 The proposals in this CP in respect of the transition are limited to the TI for GBP. However, the PRA considers that these may also set a framework for the transition of JPY and USD RFRs from Libor to an OIS at a later date, although this will depend on developments in the swap markets referencing TONA and SOFR. The PRA will update firms in due course on the implementation for the transition of these other Libor currencies in the TI.

Impact of transition on TI methodology

Credit risk adjustment

2.14 The determination of the risk-free interest rate term structure is specified in the DR.[12] The DR prescribes the application of a CRA in order to adjust for any credit risk embedded in interest rate swap rates.[13] It also prescribes the CRA calculation as the averaged difference between the interest rate swap rate and the OIS rate, subject to a maximum bound of 35 basis points and a minimum bound of 10 basis points.[14] The PRA notes that it may be necessary to amend the onshored DR in respect of the CRA (including the bounds) currently applied for Libor-based RFRs.[15] Given that SONIA and hence the OIS rates are based on overnight deposits, for the purpose of the calculation of the published RFR, the PRA considers that the residual credit risk is currently negligible.

Long-term average spread (LTAS)

2.15 The LTAS is an input to the calculation of the fundamental spread (FS) for the MA and VA measures.[16] Spreads over the basic RFR for assets of the same duration, credit quality, and asset class data over a 30-year period are input into the LTAS calculation.

2.16 The PRA proposes that the LTAS calculation should recognise the change in spreads that results from transitioning the RFR to SONIA from the point of transition onwards, and that the historic spreads (over Libor-based RFR) already embedded in the LTAS calculation would remain unadjusted. The PRA considers that this approach best reflects the requirement for the LTAS to be based on data relating to the last thirty years.[17] It also considers there is insufficient reliable data to adjust historic spreads over a period of 30 years to reflect the change in the RFR to SONIA, and that an approach of attempting to adjust historic spreads would not be practical.

12 Commission Delegated Regulation (EU) 2015/35 or 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, OJ L 12, 17.1.2015, p.1.

13 Ibid, Article 44.

14 Ibid, Article 45.

15 Chapter 11 of HMT Review of Solvency II Call for Evidence: https://www.gov.uk/government/publications/solvency-ii-review-call-for-evidence.

16 Rule 7.3 Technical Provisions.

17 DR Article 54.

Impact of transition on Solvency II approvals

Transitional measure on technical provisions

2.17 The PRA notes that for firms that have approval to apply the transitional measure on technical provisions (TMTP), or that are considering applying for approval to apply this measure, existing differences between Solvency I and Solvency II in the calibration of the RFR are reflected in the calculation of the TMTP amount. The PRA therefore proposes that the additional impact of the transition from Libor to SONIA in the calibration of the Solvency II RFR would also be eligible, in principle, for transitional relief.

2.18 Supervisory Statement (SS) 6/16 sets out the PRA's expectations for assessing materiality in the context of applying for approval to recalculate the TMTP amount in between biennial recalculations, in the event of a material change in a risk profile.[18] The PRA expects that, for most firms, the impact of the transition from Libor to the SONIA-based RFR for GBP would result in changes in the solvency coverage ratio of significantly lower than 5 percentage points. Therefore, the PRA would not generally expect firms to apply for a recalculation solely on the basis of the transition. There will be a biennial TMTP recalculation as at Friday 31 December 2021, at which point all firms will update the calculation of their TMTP amount, which will allow for the SONIA RFR change.

Matching adjustment

2.19 Firms with approval to apply the MA may have assets within their MA portfolio which reference Libor benchmarks. As recommended by the RFRWG, these referenced benchmarks will also transition to SONIA (or other relevant OIS rates for other jurisdictions). The PRA proposes that the updating of reference benchmarks to reflect this transition would not of itself be considered a new feature of these assets or a material change to the portfolio, and therefore it is expected that firms would not need to make new MA approval applications solely to allow for this update. It is further proposed that the benchmark references be updated and included in any subsequent MA approval applications.

Internal models

2.20 In accordance with the requirement in Rule 10.3 in the Solvency Capital Requirements – Internal Models Part of the PRA Rulebook, a firm with approval to use an internal model must ensure the ongoing appropriateness of the design and operations of its internal model, and that the internal model continues to appropriately reflect the risk profile of the firm. Firms with approval to use an internal model (including partial internal models) in relation to exposures to interest rate risks should consider whether their model would need to be updated to make appropriate allowance for the transition of the RFR to SONIA.

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18 November 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/maintenance-of-the-transitional-measure-on-technical-provisions-under-solvency2-ss.

3 The PRA's duty to consult

3.1 The PRA has a statutory duty to consult when introducing new rules and, when not making rules, has a public law duty to consult widely where it would be fair to do so. When doing so, the PRA provides the following in relation to the proposed policy:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective, insurance objective, and secondary competition objective;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with its duty to have regard to the regulatory principles; and
- a statement as to whether the impact of the proposed policy will be significantly different for mutuals than for other persons.

3.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[19]

3.3 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.[20]

Cost benefit analysis (CBA)

3.4 The Financial Conduct Authority, Bank of England, and members of the RFRWG have confirmed that firms cannot rely on Libor being published after the end of 2021. The transition away from Libor will therefore occur independent of the proposals set out in this CP. The CBA therefore has already included the impact of the transition in its baseline, and the analysis has considered the proposals set out in this CP on how and when the PRA implements the transition in the Solvency II TI. The PRA considers that the proposals contained within this CP would have marginal impact on UK regulatory balance sheets using the PRA's published TI to determine their technical provisions. This reflects that the proposals for the DLT assessment largely retain EIOPA's current approach.

3.5 The proposals for allowing for the transition in the LTAS calculation would only result in a very gradual change in the LTAS measure.

3.6 The PRA considered adopting a blended approach for GBP TI referencing both SONIA and Libor until the end of 2021. For the reasons set out in this CP (paragraph 2.12), the PRA does not consider a blended approach to be practical. Instead, it has proposed to implement the transition on a single date. This approach may result in slightly higher technical provisions over the period from Saturday 31 July 2021 to the end of the year, compared to a blended approach. The PRA also notes that given that Libor is planned to be discontinued at the end of 2021, any relative decrease in the technical provisions resulting from a blended implementation is both temporary and for a relatively short time period.

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19 Section 30B of the Bank of England Act 1998.
20 Section 149.

3.7 The PRA has also considered the operational impacts that the proposals in this CP may have on firms, and does not consider these to be material. The proposal that the updating of reference benchmarks would not of itself be considered a material change to an MA portfolio requiring a new MA application should help reduce the operational impact for firms with approval to apply the MA.

Compatibility with the PRA's objectives

3.8 The PRA has a statutory obligation at the end of the EU Exit transition period to publish TI, to enable UK insurers to calculate technical provisions. The current methodology for calculating the TI for GBP relies on the availability and liquidity of Libor markets, which will not be available from year-end 2021. In order to meet its objectives of safety and soundness and to ensure that policyholders are appropriately protected, the PRA considers it necessary to transition the calculation of the RFR and associated TI to SONIA, and that the proposed changes to methodologies and judgements required for implementing this transition are appropriate for the determination of technical provisions. The proposals also support the Financial Policy Committee's observation in December 2020 that market participants must continue to accelerate their plans to eliminate reliance on Libor benchmarks before year end 2021.[21]

3.9 The PRA has assessed whether the proposals in this CP facilitate effective competition. As the proposals do not include any additional requirements or expectations for firms, the PRA does not consider that they would have a negative impact on competition.

Regulatory principles

3.10 In developing the proposals in this CP, the PRA has had regard to the regulatory principles. Two of the principles have particular relevance.

3.11 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, specifically the proposal that the updating of reference benchmarks would not of itself be a material change to an MA portfolio requiring a new MA approval application.

3.12 The principle that the PRA needs to use its resources in the most efficient and economical way. The PRA considers that the proposals made in this CP, in particular those for assessment of the depth, liquidity, and transparency of the swaps and bonds markets, would result in reliable rates being used in the calculation of the RFR. This is appropriate use of PRA resources, as the PRA proposes to make use of externally published DLT data and analysis in its DLT assessments for non-GBP currencies.

Impact on mutuals

3.13 The PRA considers that the impact of the proposed changes on mutuals would be no different from the impact on other firms. This is because all firms are required to use the same TI published by the PRA.

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21 https://www.bankofengland.co.uk/financial-policy-summary-and-record/2020/december-2020.

HM Treasury recommendation letter

3.14 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.[22]

3.15 The aspects of the Government's economic policy most relevant to the proposals in this CP are:

(i) competition;

(ii) growth; and

(iii) competitiveness

3.16 Aspects (i) and (ii) have been considered in the 'compatibility with the PRA's objectives' and 'regulatory principles' sections above. The proposals would enhance the safety and soundness of firms and policyholder protection, and support sustainable growth.

Competitiveness

3.17 The proposals would ensure that UK insurers' liabilities are discounted using resilient OIS benchmarks. They would also increase the transparency of the PRA's analysis and judgements, in particular with respect to the DLT assessment. This should help maintain the UK as an attractive market for firms.

Equality and diversity

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

22 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.

Appendix

Draft amendments to Statement of Policy – The PRA's approach to the publication of Solvency II technical information

In this section, new text is underlined, and deleted text is struck through.

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3 Variations by the PRA to EIOPA methodologies and judgements

…

Basic risk free rate term structure

3.6A The basic risk free rate (RFR) for GBP will reference Sterling Overnight Index Average (SONIA) swap rates.

Calculation of the long-term average spread (LTAS)

3.6B For the LTAS calculation, the PRA will calculate the average of spreads over the RFR applicable at the time of the spread data. Therefore, following the transition of TI references from Libor to an OIS rate, historic spreads (over Libor-based RFR) already embedded in the LTAS calculation would remain unadjusted.

Assessment of the depth, liquidity and transparency of the markets

3.6C The PRA will focus its assessment of the depth, liquidity and transparency of the market (the DLT assessment) on interest rate swaps data for the markets of relevant currencies where there is an active swap market.

3.6D The PRA will use the same volume indicators as applied by EIOPA (at the end of the TP) for assessing the liquidity of the swaps market, but with the average (over one year) daily notional turnover requirement being £45 million.

3.6E The PRA will also consider in its DLT assessment additional criteria developed to avoid excessive volatility in the results of the assessment, specifically that a previously liquid market needs to drop at least 20% below one of the thresholds to be considered illiquid, and a previously illiquid market must meet both thresholds and rise at least 20% above one of the thresholds to be considered liquid. The PRA may also consider other metrics in order to supplement its assessment as required for the relevant currencies, which will be set out in its published results and analysis of the DLT assessment.

3.6F For non-GBP relevant currencies, the PRA will make use of externally published DLT data and analysis, including that published by EIOPA and the International Association of Insurance Supervisors (IAIS), to contribute to its own assessment.

3.6G The PRA will apply the granular country level EIOPA DLT assessment used for the aggregated composition of the EUR VA reference portfolio, considering amendments as necessary.