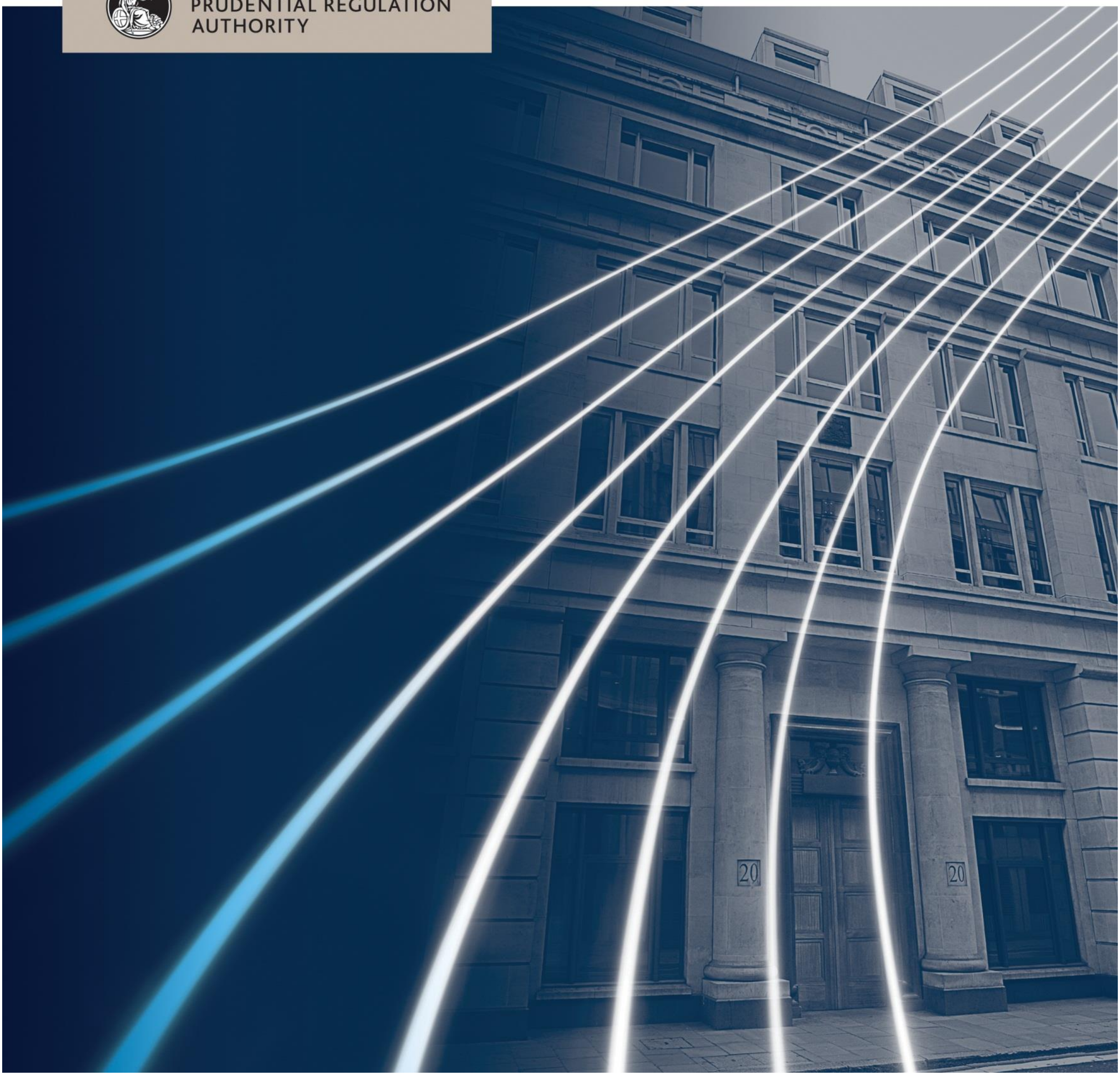
Policy Statement | PS25/19

Solvency II: Maintenance of the transitional measure on technical provisions

November 2019



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 11/19 'Solvency II: Maintenance of the transitional measure on technical provisions'.[1] It also contains the PRA's final Supervisory Statement (SS) 6/16 'Maintenance of the 'transitional measure on technical provisions' under Solvency II' (see Appendix).

1.2 The final policy is intended to provide:

- further clarity on the consistency of Solvency I and Solvency II methodologies; and
- additional guidance for firms seeking to simplify the recalculation methodology of the transitional measure on technical provisions (TMTPs).

1.3 This PS 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.

Background

1.4 In CP11/19, the PRA consulted on the general expectation to prohibit firms retrospectively updating their Solvency I methodologies and set out additional guidance to assist firms in developing simplified TMTP calculation methods.

Summary of responses

1.5 The PRA received six responses to the CP. A number of respondents considered the proposal limiting firms' making changes to their Solvency I methodology to be unduly restrictive. Respondents generally welcomed the additional guidance for firms proposing to use proportionate approaches to the TMTP recalculation methodology.

1.6 The details of the responses and the PRA's feedback and final decisions are set out in Chapter 2.

Changes to draft policy

1.7 After considering the responses, the PRA has made some changes to the draft policy, as follows:

- new text to acknowledge that the distinction between a methodology and assumption change may rely on judgement (paragraph 3.2 of the SS); and
- a new paragraph providing additional clarity of the PRA's expectations for firms using a simplified methodology for TMTP recalculation (paragraph 4.18E of the SS).

1.8 Chapter 2 sets out the PRA's feedback to the areas identified in paragraph 1.7 and also includes feedback to industry responses covering:

- previously agreed Solvency I methodology changes and the approach to dealing with live cases - firms whose discussions with the PRA in relation to specific Solvency I methodology updates had been put on hold pending the outcome of the consultation (paragraph 2.15);
- the treatment of the new risks arising within firms' Solvency I approaches (paragraph 2.16);

1 May 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-maintenance-of-the-transitional-measure-on-technical-provisions (page 2 of 2).

- the alignment of the Solvency I and Solvency II stresses and correlations (paragraph 2.23);
- simplification proposals received after Tuesday 31 December 2019 (paragraph 2.29); and
- the PRA's approach to limiting the amount of the TMTP (paragraphs 2.30 – 2.31).

1.9 The PRA considers that the above changes make the final policy clearer and do not result in any additional burden on firms compared to the original proposals. As a result, the PRA has not updated the cost benefit analysis or assessment of the impact on mutuals from the CP.

Implementation

1.10 The expectations set out in the attached SS will come into effect on the publication of the PS on Thursday 14 November 2019.

1.11 The policy set out in this PS has 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 European Union take effect.

1.12 In the event that the UK leaves the EU with no implementation period in place, the PRA has assessed that the policy would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018' for further details.[2]

2 Feedback to responses

2.1 The PRA has considered the responses received to the CP. This chapter sets out the PRA's feedback to those responses, and its final decisions. It has been structured broadly along the same lines as the proposals in the CP.

Consistency of the Solvency I and Solvency II bases

Regular Solvency I reviews

2.2 The PRA proposed to remove the expectation of firms to review their Solvency I methodologies at regular intervals.

2.3 Two respondents were supportive of the proposal. Another respondent has been aligning its internal model and Individual Capital Assessment (ICAS) methodologies and expressed particular concern over the proposal. A fourth respondent considered that the change in approach could create ambiguity between what is considered an assumption versus a methodology change.

2.4 The PRA considers that the purpose of TMTP is to help firms mitigate differences between the actual Solvency I calculations that firms used and Solvency II over a period of up to 16 years. The PRA does not consider that updates to the actual Solvency I methodology made after Friday 1 January 2016 to represent a difference that firms should be able to mitigate by a transitional measure. This position is consistent with the publication of the final policy set out in PS31/18 'Solvency II: Equity release mortgages'.[3]

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2 April 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

3 December 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages.

2.5 The PRA considers industry responses covering the alignment of the internal model and ICAS stresses to be a form of simplification. It has therefore been covered at paragraph 2.24 of this PS.

2.6 The PRA acknowledges that the distinction between a methodology and assumption change may rely on judgement. The PRA has added new text to paragraph 3.2 of SS6/16 (see the appendix) to reflect this. Firms are expected to make the most appropriate determination and to discuss the decision with their supervisors.

Retrospective changes and evaluation of new risks

2.7 The PRA proposed that it does not expect firms to make any further retrospective changes to their Solvency I methodologies (apart from specific changes that the firm has previously discussed and agreed with the PRA). The PRA also proposed that firms evaluate new risks identically for both Solvency I and Solvency II bases unless the firm can sufficiently demonstrate that the risk was addressed in a different way in methodologies used before Solvency II came into effect.

2.8 A number of respondents felt that the proposal was unduly restrictive and would not provide the expected relief from the burden of maintaining legacy systems. One respondent felt that the proposed text would prohibit their desire to decommission their current models and systems once the International Financial Reporting Standard (IFRS) 17 went live. Another respondent queried whether the proposal to fix the Solvency I methodologies on Thursday 31 December 2015 imposed a restriction that was not present or applicable in the PRA rules and guidance (GENPRU 1.2.26R and INSPRU 7) which firms are required to use for the purpose of the TMTP calculations in accordance with Regulation 54 of the Solvency 2 Regulations 2015 (2015/575). Another respondent felt that the proposal unfairly penalised firms who had adopted methodologies that were more prudent than strictly required by the Solvency I rules.

2.9 Two respondents expressed support for the proposal to align the Solvency I and Solvency II methodologies for new risks with caveats including a concern that the proposal could give rise to an uneven playing field.

2.10 Two respondents considered that the proposed wording was ambiguous. It was not clear for example whether firms were being asked to unwind any changes made to the Solvency I methodology after Solvency II came into effect.

2.11 For the reasons explained in paragraphs 2.12 to 2.14, the PRA concludes that TMTP should only serve to smooth firms' transition to Solvency II technical provisions (TP) calculations from their actual pre-Solvency II TP calculations, not from calculations that they might theoretically have used under INSPRU 7 to calculate Solvency I TPs. The PRA considers this policy position to be consistent with the underlying purpose of transitional measures.

2.12 The PRA also considers this approach to be consistent with the way in which INSPRU 7 was applied by firms. Under INSPRU 7, firms took a holistic approach to the calculation of their TPs. Individual elements of that calculation may have included a greater degree of prudence than the PRA would have considered necessary to be consistent with some of the principles set out in INSPRU 7, while other elements may have been less prudent. It was for a firm to determine whether its overall approach, in aggregate, was appropriate to satisfy INSPRU 7 and the PRA would have considered that overall approach, where applicable, in the setting of Individual Capital Guidance (ICG). TMTP is intended to allow a firm to transition from that INSPRU 7 approach to the requirements of Solvency II. Allowing what amounts to retrospective changes to some elements of the ICAS TP calculations carried out under INSPRU 7 would result in a firm's ICAS TPs no longer genuinely representing the INSPRU 7 position from which it is permitted to transition using TMTP. In the PRA's view, this would not be consistent with either Article 308d of the Solvency II Directive or Regulation 54 of the Solvency 2 Regulations 2015 (2015/575).

2.13 The PRA also notes that experience and expertise in the application of INSPRU 7 necessarily deteriorates over time and that it will become increasingly difficult and complex for firms and for the PRA to determine whether a proposed change in some aspect of a firm's approach to calculating its ICAS TPs would actually have been consistent with INSPRU 7 as it applied pre-Solvency II. This is relevant not only to the correct application of Regulation 54 but also to the desire expressed by firms to simplify the TMTP calculation.

2.14 The PRA also considered the policy set out in paragraph 3.3A of SS6/16 to be consistent with the position reached and communicated in respect of ICAS technical provisions (TPs) and TMTP in PS31/18 'Solvency II: Equity release mortgages'. In that PS, the PRA confirmed that it would not proceed with its originally proposed expectation that firms should incorporate, in the calculation of their Solvency I ICAS TPs, the principles and expectations for measuring risks in Equity Release Mortgages (ERMs) that were set out in SS3/17.[4] The PRA noted that these principles and expectations had not been specifically articulated before Solvency II came into force, nor were they consistently applied and understood at that time. The PRA noted that compliance with such an expectation could have resulted in some firms having to calculate their ICAS TPs by reference to an approach or methodology that they were not in fact using prior to Solvency II and that this would not be consistent with the Solvency II Directive's provisions regarding TMTP.

2.15 The PRA has however carefully considered the responses to its proposal in this area from firms that have already made some updates to the methodology used. The PRA has concluded that requiring such firms to retrospectively unwind Solvency I methodology updates made after Thursday 31 December 2015 which have previously been agreed with the PRA would be disproportionate, as the unwinding of these limited changes would place an undue burden on these firms.

2.16 As the scope of any changes is very limited, the PRA does not consider that this proportionate approach gives rise to any material competitive advantage. The PRA has also decided that firms who were considering making changes to Solvency I methodologies and put these on hold pending the outcome of the consultation should not be precluded from making similar limited changes to their Solvency I methodology, as that would unfairly penalise such firms merely on the basis of timing. The PRA will now proceed to consider proposals that have already been made by such firms. The PRA will not however be prepared to consider proposals for any further Solvency I methodology updates that firms may have wanted to propose with immediate effect.[5]

2.17 The PRA considers the proposal for firms evaluating new risks to be a consequence of the principle that the TMTP should allow firms to transition from the Solvency I methodology that they used at the end of that regime to Solvency II. If a firm is able to demonstrate sufficiently that a new risk was appropriately covered by its Solvency I methodology as applied at Thursday 31 December 2015, then the firm should adopt their Solvency I approach. The PRA does not expect firms to reflect features specific to Solvency II, such as those to arise as a result of the matching adjustment eligibility criteria within that Solvency I approach. However, if the new risk is not covered by the firm's Solvency I methodology, for example because the risk was acquired after Thursday 31 December 2015, then the Solvency II approach should be the default. The PRA considers this

4 September 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss.

5 Save in exceptional circumstances.

approach to be pragmatic and avoids complicated approaches to reverse engineer whether, and if so, how a new risk might have been allowed under Solvency I in broad terms.

Recalculations of the transitional measure

Simplification methods and approaches

2.18 The PRA proposed that firms consider whether, and if so, what simplifications are appropriate for its own use. The PRA considered it was unlikely that a single generic approach would be suitable to simplify TMTP for all firms. Firms are expected to discuss any simplification methods with their supervisors.

2.19 Respondents broadly agreed that a single generic approach was unlikely to be appropriate to simplify TMTP for all firms. Respondents supported the proposal for firms to develop and discuss their own simplification approaches with their supervisors.

2.20 Paragraph 4.18C of SS6/16 sets out two examples that the PRA considered may be useful for firms to consider in addition to firms' proposed approaches. Separately, the PRA expects firms to discuss their simplification proposals ahead of the next formal TMTP recalculation date, as set out in the original proposals.

2.21 Three respondents found the examples helpful, although one felt that the PRA's response to some initial proposals indicated that the level of evidence required to implement any change is unduly onerous. One respondent sought clarification as to whether the alignment of Solvency I and Solvency II stress and correlations could be used for capital calculations. Another respondent highlighted a particular issue with the treatment of their staff pension scheme and sought clarity on the viability of their approach.

2.22 The PRA considers that it would be helpful to distinguish between simplifications that affect the requirements set out at Condition 1 and Condition 3 of Regulation 54 of the Solvency 2 Regulations 2015 (2015/575).

2.23 Condition 1 of Regulation 54 of the Solvency 2 Regulations 2015 (2015/575) prohibits insurers from taking more TMTP than the maximum permitted. The PRA expects firms to provide sufficient justification or analysis to demonstrate that a TMTP simplification is between zero and the maximum permitted.

2.24 The Solvency I and Solvency II stresses and correlations are relevant for the purpose of calculating Condition 3 of Regulation 54 of the Solvency 2 Regulations 2015 (2015/575). The PRA considers that it may be possible for firms to align the Solvency I and Solvency II stresses and correlations as part of a simplification approach. However in some cases where there may be specific differences in the Solvency I and Solvency II approaches, for example in the modelling of expenses or the approach to aggregation of risks, then the impact of these differences may need to be preserved. The appropriateness of aligning stresses and correlations would therefore need to be assessed on a case-by-case basis.

2.25 The treatment of the staff pension scheme may be considered under the PRA's discretion over the Financial Resource Requirement test and is covered at paragraphs 2.30 – 2.31 of this PS.

Demonstrating simplifications remain appropriate

2.26 The PRA proposed that firms using a simplified methodology for TMTP recalculation should demonstrate that this will result in 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).

2.27 Two respondents sought clarity as to how many simplifications would need to be demonstrated. One respondent thought that the proposal would be onerous to meet; and wanted further clarification on the extent of the evidence required to demonstrate a non-material difference. Another respondent flagged that an ongoing assessment would require maintaining legacy systems, which they considered to be contrary to the intended purpose of the simplification approach. Another respondent asked whether the PRA would be open to accepting simplification proposals beyond the Tuesday 31 December 2019 formal recalculation date.

2.28 Firms are expected to demonstrate, through justification or analysis that the conditions that the simplification relies on, for example the business mix or risk transfer arrangements, continue to be relevant at each formal recalculation date. Firms may have regard to a materiality or similar framework to demonstrate that the simplification does not result in a deduction that is materially different to the approach required to demonstrate compliance with Regulation 54 of the Solvency 2 Regulations 2015 (2015/575). Nevertheless, the simplification methodology will remain firms' responsibility. The PRA has added a new paragraph (4.18E) to reflect this.

Simplification proposals

2.29 Firms should discuss specific simplification proposals with their supervisor.

2.30 The PRA will consider any simplification proposal received from firms at any time after this policy becomes effective.

Financial Resource Requirement and PRA discretion

2.31 The PRA generally expects to apply a limit to the amount of firms' TMTP to ensure that Condition 3 of Regulation 54 of the Solvency 2 Regulations 2015 (2015/575) (the FRR test) is satisfied. The PRA may, in exceptional circumstances, not apply a limit at all or apply a limit that is less than the maximum limit that may be applied under Regulation 54(6). The PRA does not intend to provide a comprehensive list of examples where discretion may be applied.

2.32 However, the treatment of the staff pension scheme is highlighted as an example where the PRA would consider allowing firms to vary the calculation of the FRR test so that the limit applied is less than the maximum. Differences in the way pension scheme obligations are recognised under ICAS and Solvency II could increase the likelihood that the assessment of Condition 3 of Regulation 54 of the Solvency 2 Regulations 2015 (2015/575) causes solo firms TMTP to reduce. Firms in this situation should discuss the matter further with their supervisor.

Appendices

SS6/16 'Maintenance of the 'transitional measure on technical provisions' under Solvency II': https://www.bankofengland.co.uk/prudential-regulation/publication/2016/maintenance-of-the-transitional-measure-on-technical-provisions-under-solvency2-ss.