Supervisory Statement | SS13/15

Appendix 2.13

Solvency II: surplus funds

March 2015

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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1 Introduction

1.1 This supervisory statement is addressed to all UK Solvency II firms which write[1] with-profits insurance business and which are therefore required to calculate surplus funds. It sets out the Prudential Regulation Authority's (PRA's) expectations of firms in relation to surplus funds.

1.2 In particular, this statement sets out the PRA's expectations of firms in relation to the following topics:

- interaction of the surplus funds calculation with the calculation of technical provisions; and
- the calculation of surplus funds.

1.3 This statement expands on the PRA's general approach as set out in its insurance approach document.[2] By clearly and consistently explaining its expectations of firms in relation to the particular areas addressed, 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. 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.

1.4 This statement has been subject to public consultation[3] and reflects the feedback that was received by the PRA.

1.5 Firms should have regard to the Solvency II Regulations as well as the PRA Rulebook when calculating surplus funds and considering whether they meet the criteria for classification as Tier 1 own funds. In particular, Article 69 sets out a list of own funds items and Article 71 the features determining classification as Tier 1 own funds.

2 Interaction of the surplus funds calculation with the calculation of technical provisions

2.1 Article 78 of the Solvency II Directive requires a firm to include, when calculating its technical provisions, all payments to policyholders, including future discretionary bonuses, unless those payments constitute surplus funds that fall within Article 91(2). This is reflected in Technical Provisions 9.1(3) in the Technical Provisions Part of the PRA Rulebook. Article 91 provides that surplus funds are not to be considered insurance and reinsurance liabilities, to the extent that national law permits and where those surplus funds meet the requirements for Tier 1 own funds.

2.2 The Surplus Funds Part of the PRA Rulebook is the national law provision, referred to in Article 91(2) of the Solvency II Directive, which prescribes the extent to which surplus funds shall not be treated as insurance or reinsurance liabilities and therefore the extent to which they affect the calculation of a firm's technical provisions.

2.3 The PRA expects that surplus funds will normally meet the criteria for classification as Tier 1 own funds as referred to in paragraph 1.5. While surplus funds within a with-profits fund may satisfy these criteria, firms should be aware of any other restrictions that may apply to such funds by virtue of their being within the with-profits fund, in particular policyholder fairness rules in the FCA Handbook. As a consequence, such surplus funds are likely to be treated as part of a ring-fenced fund under the Solvency II Regulations.

2.4 The calculation of surplus funds in the Surplus Funds Part does not refer to or include a risk margin. The risk margin is a Solvency II requirement in respect of technical provisions and does not therefore fall within the scope of domestic requirements for the calculation of surplus funds. However, this does not affect the Solvency II requirements for firms to calculate and recognise the risk margin element of technical provisions in respect of their business as a whole, including with-profits business.

3 Surplus funds calculations

3.1 Surplus Funds 3.2 generally requires the value of with-profits policy liabilities to be calculated on the basis of a retrospective approach set out in Surplus Funds 3.3. However, where this approach would not adequately reflect the value of the liabilities, or the firm is able to demonstrate that this approach is not practicable, then the prospective basis for calculation in Surplus Funds 3.4 is required. The PRA expects firms to consider whether the application of the retrospective approach would be practicable given the nature of their with-profits policies and, even if possible, whether the results would be meaningful or an appropriate basis for the calculations. While each firm will need to consider its own specific circumstances, whole of life policies or other policies where the result of the retrospective calculation might be negative or significantly lower than the value calculated using the prospective approach are examples where the prospective approach might be necessary.

3.2 Calculations of with-profits policy liabilities are determined on the basis of the aggregate value in respect of

(1) https://eiopa.europa.eu/publications/consultations/EIOPA_EIOPA-BoS-14-169-Final_Report_RFF.pdf.
(2) *The Prudential Regulation Authority's approach to insurance supervision*, June 2014; www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf.
(3) *PRA Consultation Paper CP16/14*, 'Transposition of Solvency II: Part 3', August 2014; www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1614.pdf.

each with-profits policy. For this purpose calculations may be based on groupings of similar policies (or other approximations) provided that firms can demonstrate that:

(a) where approximations or generalisations are made they are likely to provide the same, or a higher, result than a separate calculation for each with-profits policy;

(b) the grouping of policies does not materially misrepresent the underlying exposure or misstate the costs of guarantees, options or smoothing; and

(c) the selection of groupings is based on policies with similar attributes including the status of guarantees.

3.3 The PRA expects firms to ensure that the choice of groupings is appropriate having regard to (a) to (c) above each time it calculates surplus funds.

3.4 The reference to 'permanent enhancements' within Surplus Funds 3.3(3) is intended to capture amounts previously added to with-profits policy liabilities which a firm expects to be permanent at the time of the surplus funds calculation (ie to apply in all but the most extreme adverse circumstances). Any change in the additions that are considered permanent over time should be reflected in subsequent calculations of surplus funds.

3.5 The reference to 'miscellaneous surplus' within Surplus Funds 3.3(4) is intended to capture surplus or deficit arising from the experience of the with-profits fund, that may have been allocated to the value of with-profits policies prior to (or on) the valuation date. Examples include mortality or expense experience (relative to expectations) or profits or losses arising from non-profit business within the with-profits fund.

3.6 Surplus Funds 3.5 specifies the extent to which future discretionary additions to guaranteed benefits and discretionary payments should be included in benefits payable for the purposes of the prospective calculation in Surplus Funds 3.4. In arriving at their projections of future discretionary benefits firms will need to comply with the requirements of the Solvency II Regulations as well as the intent and provisions of the Surplus Funds Part. The PRA would not expect a firm to include within benefits payable distributions from the estate that it might make over the life of the with-profits policies were the with-profits fund in run-off, or that it expects to make if it is currently in run-off.

3.7 The PRA expects that firms will have regard to their current expectations as to payments which are likely to be made taking into account the principles underlying the retrospective approach. This does not mean that a firm which uses the prospective calculation to value some or all of its with-profits policy liabilities is also required to perform a retrospective calculation. Firms' current expectations as to an affordable, prudent and realistic level of distributions should inform their projections of future discretionary benefits.