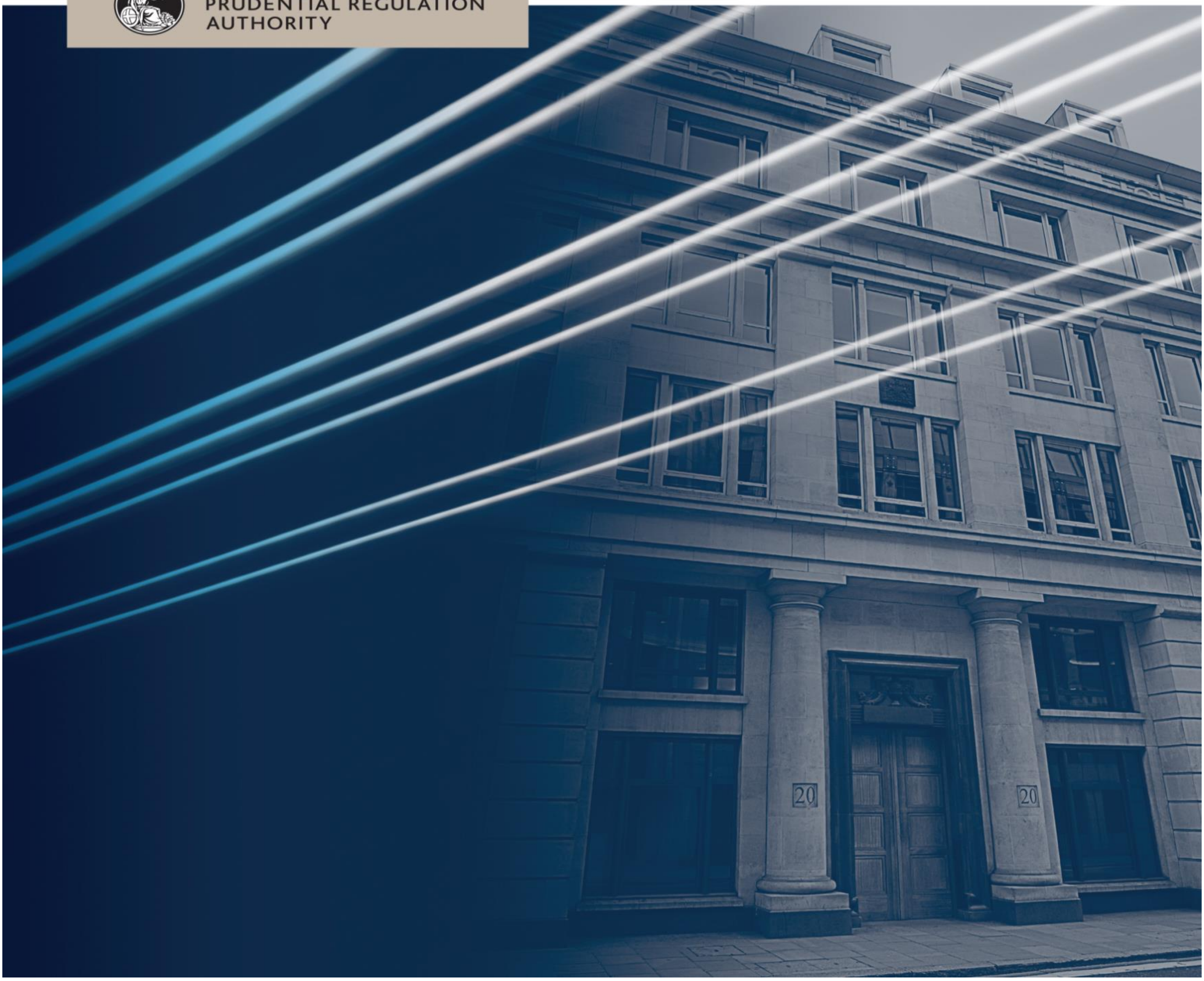
Supervisory Statement | SS17/15

Solvency II: transitional measures on risk-free interest rates and technical provisions

November 2016

(Updating March 2015)

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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Contents

1 Introduction

1.1 This supervisory statement[1] is of interest to all UK firms that fall within the scope of the Solvency II Directive ('the Directive'),[2] and to the Society of Lloyd's. In particular, it is relevant to firms that are considering applying for, or that have been granted approval to use, either the transitional measure on the risk-free interest rate or the transitional measure on technical provisions.

1.2 It sets out the calculation and application process to be used for these transitional measures, as specified in Transitional Measures 10 and 11 in the Prudential Regulation Authority (PRA) Rulebook.

1.3 This statement should be read in conjunction with those chapters of the Transitional Measures Part, the rules in the rest of the Solvency II Sector of the PRA Rulebook, the Solvency 2 Regulations (2015/575),[3] the European Insurance and Occupational Pensions Authority (EIOPA) Level 3 Guidelines and the PRA's insurance approach document.[4]

1.4 This supervisory statement expands on the PRA's general approach as set out in its insurance approach document. 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.

1.5 Deleted.

1.6 Deleted.

1.7 Deleted.

1.8 Deleted.

1.9 Deleted.

2 Transitional measure on the risk-free interest rate

Calculation of the single interest rate

2.1 In meeting the requirements set out in Transitional Measures 10.2(1) and 10.2(2), the PRA expects firms to determine the single interest rate in 10.2(1) in such a manner that the comparison with the annual effective rate in 10.2(2) is meaningful. For example, firms could compute the annual effective rate that, when applied to the cash flows of the admissible insurance and reinsurance obligations, results in a present value that is equal to the value of the admissible insurance obligations calculated in accordance with Chapter 1 of the Prudential Sourcebook for Insurers (INSPRU 1) as at 31 December 2015. In their applications, firms are expected to explain and justify the method used.

1 On 21 November 2016, this SS was updated – see appendix for full details.
2 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast).
3 http://www.legislation.gov.uk/uksi/2015/575/contents/made.
4 Available at www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.

Interaction with the volatility adjustment

2.2 Where a firm includes a volatility adjustment within the Solvency II relevant risk-free interest rate, but also intends to use the transitional measure on the risk-free rate, the annual effective rate calculated in Transitional Measures 10.2(2) should reflect the effect of the volatility adjustment. The admissible insurance and reinsurance obligations should then be discounted at a rate equal to the basic risk-free rate plus the transitional adjustment to the risk-free rate. A volatility adjustment should not be added on top of this, as that would result in double counting the effect of the volatility adjustment (which was already reflected when determining the transitional adjustment).[1]

3 Transitional measure on technical provisions

3.1 Under Solvency II, firms may apply to the PRA for approval to apply a transitional measure for technical provisions (TMTP). This chapter sets out the PRA's expectations of the calculation methodology that firms should use for the transitional measure.

3.2 The scope of this chapter is limited to the calculations a firm must perform to apply the transitional deduction.

Calculation of the transitional measure before application of the limit

3.3 Solvency I Pillar 2 insurance liabilities are the starting point for the transitional deduction. They will capture all relevant features of the liabilities, including those that may not be adequately reflected in a firm's Solvency I Pillar 1 technical provisions as set out in INSPRU 1.

3.4 When calculating the Solvency I Pillar 2 insurance liabilities, the PRA's default assumption is that firms will use methodologies, assumptions and input data that are consistent with their current Solvency I Pillar 2 insurance liabilities valuation basis, including any margins held (eg unearned premium reserves, management margins), or amounts included within the insurance liabilities following guidance given by the PRA or its predecessor.

3.5 Where the Solvency I Pillar 2 insurance liabilities valuation basis contains material differences from that which was used for the firm's most recent Individual Capital Assessment (ICA) review, these differences should be clearly explained within the application, along with an indication of their impact.

3.6 Where firms have voluntarily decided to hold additional margins alongside their Solvency I Pillar 2 insurance liabilities, and do not believe it would be appropriate for these margins to be included when calculating the transitional deduction, firms should discuss this with their supervisory contact. Where Individual Capital Guidance (ICG) was issued taking into account the holding of these additional margins, this may also need to be revisited for the purposes of assessing the limit to the amount of the deduction. Firms who believe they will be in this position should notify the PRA at the earliest opportunity.

Part VII transfers

3.7 Approval for use of the TMTP remains with the legal entity which sought the approval. For business transferred under Part VII of Financial Services and Markets Act (2000) (FSMA), any associated TMTP relief which applied within the ceding firm will not therefore be automatically transferred with the liabilities. Both the transferor and transferee should consider how their risk profile has changed.

1 See Transitional Measures 10.5(1) in the PRA Rulebook.

3.8 Where the business transferred is material and should the transferee firm seek to benefit from the TMTP relief in respect of the transferred business, the PRA's view is that an application to recalculate the value of the TMTP, would be reasonable where the business transferred was written on or before 31 December 2015.

3.9 Furthermore the PRA's expectation is that the transferor will also need to seek approval to recalculate the value of the TMTP. The value of the TMTP within the transferor would be expected to decrease, reflecting the reduction in business in force.

3.10 The PRA notes that the amount of the TMTP in respect of liabilities not subject to the transfer may also change as a result of the transaction. This might arise where the transaction results in a change to the assumptions underlying the technical provisions (eg expenses), or the balance of risks in the solvency capital requirement (SCR) and hence the risk margin.

Reinsured business

3.11 The reinsurance of risks arising from liabilities can result in a similar economic impact to the transfer of business to a third party. A reinsurance arrangement and transfer of business are, however, not equivalent transactions. The reinsurance arrangement is a new contract written by the reinsuring entity which transfers risks, with the original contract remaining in force between the cedant and their policyholder(s).

3.12 Where reinsurance materially changes the value of technical provisions used to calculate TMTP in the cedant, the PRA expects that the cedant will seek approval to update the calculation of the TMTP.

3.13 The PRA expects that there may be circumstances under which it would be reasonable for the reinsurer to seek approval to update its calculation of the TMTP given the expected increase in technical provisions which would result from the transaction. However, given the wide variation in the nature of reinsurance arrangements, firms should discuss the position with their PRA supervisory contact, and the PRA will need to make a decision on a case-by-case basis considering the specific details of the proposed transaction.

Scope and granularity of application of the transitional measure

3.14 The PRA expects the application of TMTP to be limited to business that was in force on or before 31 December 2015.

3.15 Firms can select the individual Homogeneous Risk Groups (HRGs) that they wish to include within the scope of the transitional deduction. For this purpose, HRG has the meaning as under Technical Provisions 10.1, ie the HRGs are those that are used to segment the technical provisions under Solvency II.

3.16 The PRA expects that the only limitations on the level of granularity chosen for the scope of the deduction are that:

(i) an HRG should not be 'split', with part of the HRG in scope of the transitional calculation and part of the HRG excluded from scope;

(ii) it should be possible for the firm to identify corresponding HRGs for the purpose of the Solvency I Pillar 2 insurance liabilities calculation, and to calculate Solvency I Pillar 2 insurance liabilities in respect of these HRGs reliably; and

(iii) the firm must demonstrate that the technical provisions calculations made at HRG level can be reconciled with the technical provisions calculation for the entity as a whole.

Limiting the amount of the transitional measure

3.17 The PRA's view is that an ability to limit the amount of the transitional deduction is likely to be necessary to ensure that the deduction will not reduce the current level of policyholder protection. The assessment of whether it is necessary to limit the amount of the deduction is made at the level of the legal entity, regardless of the scope that the firm has chosen for calculating and applying the deduction.

Review of Individual Capital Guidance

3.18 The PRA is aware that at 31 December 2015, some firms had not had a review of their Individual Capital Assessment (ICA) or received Individual Capital Guidance (ICG) for some time. The PRA does not generally expect to revisit or reassess ICG as part of the process of approving the transitional deduction. However, where firms believe that the assumptions underlying their most recent ICA review and ICG are out of date, and that the effect on the resulting transitional deduction is material, the PRA will consider conducting a proportionate review of those areas of the firm's ICA that have altered since ICG was last set.

3.19 When deciding whether to undertake such a review, the PRA will consider whether the resource burden involved for the firm and the PRA would be proportionate.

4 Ongoing supervision of the TMTP

Limiting the amount of the transitional measure in future years

4.1 The PRA's default assumption is that once any limit on the amount of the transitional deduction has been determined, it will not need to be assessed again unless the transitional deduction is recalculated at either the firm's or the PRA's initiative. Assuming the deduction is not recalculated, it is expected to run off linearly each year from its starting amount until it reaches zero.

Recalculations of the transitional deduction

4.2 Deleted.

5 Management of the run-off of the TMTP in future years

5.1 There is a sixteen-year linear run off for the TMTP.[1]

Capital releases

5.2 Where firms are reliant on the TMTP in order to cover their SCR, they will be required to submit a phasing-in plan to the PRA.[2]

5.3 The use of transitional measures, regardless of whether or not they are needed to cover the SCR, will not prevent firms from paying dividends or releasing capital from subsidiaries.

5.4 However, firms reliant on the TMTP to cover their SCR are expected to be able to demonstrate that their capital position is sustainable under a range of operating conditions after allowing for any capital distributions and the TMTP run-off. This is likely to take the form of an updated phasing-in plan, and the PRA expects firms to evidence the adequacy of capital resources, stress-testing analysis and a medium-term capital plan before making any capital distribution.

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1 Regulation 54 of The Solvency 2 Regulations 2015 (2015/575); www.legislation.gov.uk/uksi/2015/575/contents/made.
2 Transitional Measures – Phasing-in Plan 12.1(3) in the PRA Rulebook.

Run-off of TMTP compared with technical provisions

5.5 Firms are expected to allocate the aggregate the TMTP by class of business and these lines of business may run off faster or slower than the 16 years for the TMTP. Where the liabilities run off more quickly this could lead to firms carrying a significant TMTP for business which is no longer in force or has substantially reduced volumes. Alternatively the TMTP could run off more quickly than the associated liabilities. In this instance, there may be a strain on the emergence of surplus and consequent expected deterioration in the solvency position of the firm.

5.6 The PRA therefore expects firms as part of their risk management to consider carefully:

- the projected risk profile relative to that implicit in the initial application for the TMTP; and
- the adequacy of technical provisions net of any TMTP.

5.7 The PRA expects that the amount of the TMTP relative to the technical provisions for business remaining in force will be monitored on a continuing basis in firms' own risk and solvency assessments (ORSA).

5.8 If a firm's ORSA highlights the risk that the TMTP may become disproportionately large, because of differences in the rate of run-off of the business and the TMTP, or if the surplus emerging from the business is not sufficient to support the projected TMTP run-off, the PRA would expect the firm to set out how this risk will be managed. Possible mitigants could include restricting the amount of the TMTP or setting up a provision to cover the potential shortfall.

6 The approval process

6.1 Firms wishing to use the transitional measures on the risk-free interest rate or on technical provisions may submit an application to the PRA electronically. For planning purposes, the PRA asks firms to notify their usual supervisory contacts at the earliest opportunity if they intend to make an application.

6.2 For the approval process on the transitional measures, the PRA intends to apply the following timeframes:

- within 30 days of receiving the application, confirm whether or not the application is complete; and
- within six months of receiving a completed application, determine the application, and give the firm written notice of that determination.

6.3 If further information is required from the firm during the review, the PRA will request this information in writing.

6.4 When submitting an application for these transitional measures, firms should inform the PRA of any other approvals for which they have applied. The PRA encourages firms to also give details of any other approvals for which they intend to apply.

6.5 As part of the application process the PRA may ask firms to obtain an external validation of the calculations they have performed. In such cases, the scope and timescales for the validation will be agreed with firms on a case-by-case basis.

7 Verification of calculations

7.1 The PRA expects that the calculation of the TMTP and the resulting quantum of the deduction, and similarly, any calculation using the transitional measure for the risk-free interest rates and the resulting quantum of the deduction that the use of these risk-free interest rate implies, will be overseen by the audit committee of the firm. The chair of the audit committee will be asked to provide written confirmation to the PRA that the numbers are suitable for use and meet the requirements of the written notice. This should be done for the opening Solvency II balance sheet, repeated after any recalculations are performed, and on an annual basis. For the annual review, where no recalculation has been performed in between periods, the audit committee is only required to confirm that there has been no change in risk profile that would have required a recalculation, and that the TMTP has been appropriately reduced in line with Solvency II requirements.

8 Interaction with other Solvency II approvals and contingency planning

8.1 Firms submitting applications for multiple Solvency II approvals, including for the internal model, are expected to understand any dependencies between the applications and how these may affect the order in which they submit their applications. In addition, as a result of the relationship which exists between certain approvals, firms are also expected to have a contingency plan in case they do not receive approval for applications where dependencies exist.

8.2 Where firms apply for the transitional deduction at the same time as applying for other approvals, the PRA may ask firms to provide sensitivity tests showing the impact on the transitional deduction if the other applications were to be rejected.

Appendix – SS17/15 updates

SS17/15[1] was originally published on 20 March 2015 following CP3/15, 'Solvency II: transitional measures and the treatment of participations'.[2]

This appendix details the changes that were made to this supervisory statement (SS) following its initial publication.

21 November 2016

This update makes the following amendments:

- paragraph 1.4: updates the text regarding the purpose of this statement and how this enables the PRA to meet its statutory objectives;
- paragraphs 1.5 to 1.9: deleted, as this information is included in the policy statement (PS);
- paragraph 3.2: updated to remove the reference to pre-Solvency II technical provisions;
- paragraphs 3.7 to 3.10: set out the PRA's expectations for Part VII transfers;
- paragraphs 3.11 to 3.13: set out the PRA's expectations for reinsured business;
- paragraph 3.14: sets out the limits of the transitional measure for technical provisions;
- paragraphs 3.18 to 3.19: set out the PRA's expectations regarding the review of the individual capital guidance;
- the section on the recalculation of the transitional measure (paragraph 4.2) has been removed from this statement and a separate supervisory statement SS6/16[3] was issued in May 2016 with this information;
- paragraphs 5.1 to 5.8: set out the management of the run-off of transitional measure on technical provisions (TMTP) relief in future years;
- paragraph 6.4: updates the previous paragraph 5.4 to request firms to inform the PRA of any other approvals for which they intend to apply, but no longer limits this to the next twelve months;
- paragraph 7.1: sets out the PRA's expectations for the verification of calculations; and
- throughout this SS: references to the Directive have been updated with references to the PRA Rulebook, where appropriate.

It should be noted that the information in this supervisory statement does not affect the content of SS6/16 'Recalculation of the 'transitional measure on technical provisions' under Solvency II', published in May 2016.

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1 March 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss1715.aspx.
2 January 2015; www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp315.aspx.
3 Available at www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss616.aspx.