Supervisory Statement | SS18/16

Solvency II: longevity risk transfers

November 2016

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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1 Introduction

1.1 This supervisory statement is addressed to all UK firms that fall within the scope of the Solvency II Directive ('the Directive'),[1] and to Lloyd's. It sets out the Prudential Regulation Authority's (PRA's) views on the general issues arising from longevity risk transfers, and clarifies the PRA's expectations on UK insurers and reinsurers carrying out these transactions as either the buyer or the seller of longevity protection.

1.2 This statement should be read in conjunction with the PRA's rules in the Solvency II Sector of the PRA Rulebook and the PRA's insurance approach document.[2]

1.3 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.

1.4 Longevity risk is the risk that policyholders, pension scheme members or other underlying beneficiaries, in aggregate, live longer than expected. The main life insurance products exposed to this risk are immediate and deferred annuities, although certain health contracts and possibly with-profits funds may also be exposed. In addition, there is likely to be some exposure to longevity risk in an insurer's own staff pension scheme, if this is defined benefit. There is also growing longevity exposure among general insurers in relation to periodic payment orders.

1.5 The PRA recognises that there has been an active market in the transfer of longevity risk for a number of years. However, the PRA would be concerned if firms became active in this market for reasons other than seeking genuine risk transfer.

2 Risks associated with longevity risk mitigation measures

2.1 An insurer accepting risk from, transferring risk to, or hedging risk with, a single or small number of counterparties (or connected counterparties) may expose itself to possibly significant levels of counterparty risk. Readers are also referred to SS20/16, 'Solvency II: reinsurance – counterparty default risk'.[3]

2.2 Solvency II introduces specific risk management rules which require insurers and reinsurers to have an effective risk management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis, the risks facing them both now and potentially in the future (see Rule 3.1 in the Solvency II Firms – Conditions Governing Business Part of the PRA Rulebook). The PRA accordingly expects firms to monitor, manage and mitigate these concentration risks. This includes risks which are covered by the solvency capital requirement (SCR) as well as those which are not. In practice this means that holding capital under the SCR in relation to counterparty default risk may not be sufficient in and of itself to mitigate this risk – additional measures besides capital may be necessary.

1 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).
2 Available at www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.
3 November 2016; www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss2016.aspx.

3 Notification

3.1 In order to supervise firms' risk management practices, the PRA expects to be notified of 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. As well as allowing the PRA to gain a fuller picture of the market, this 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.