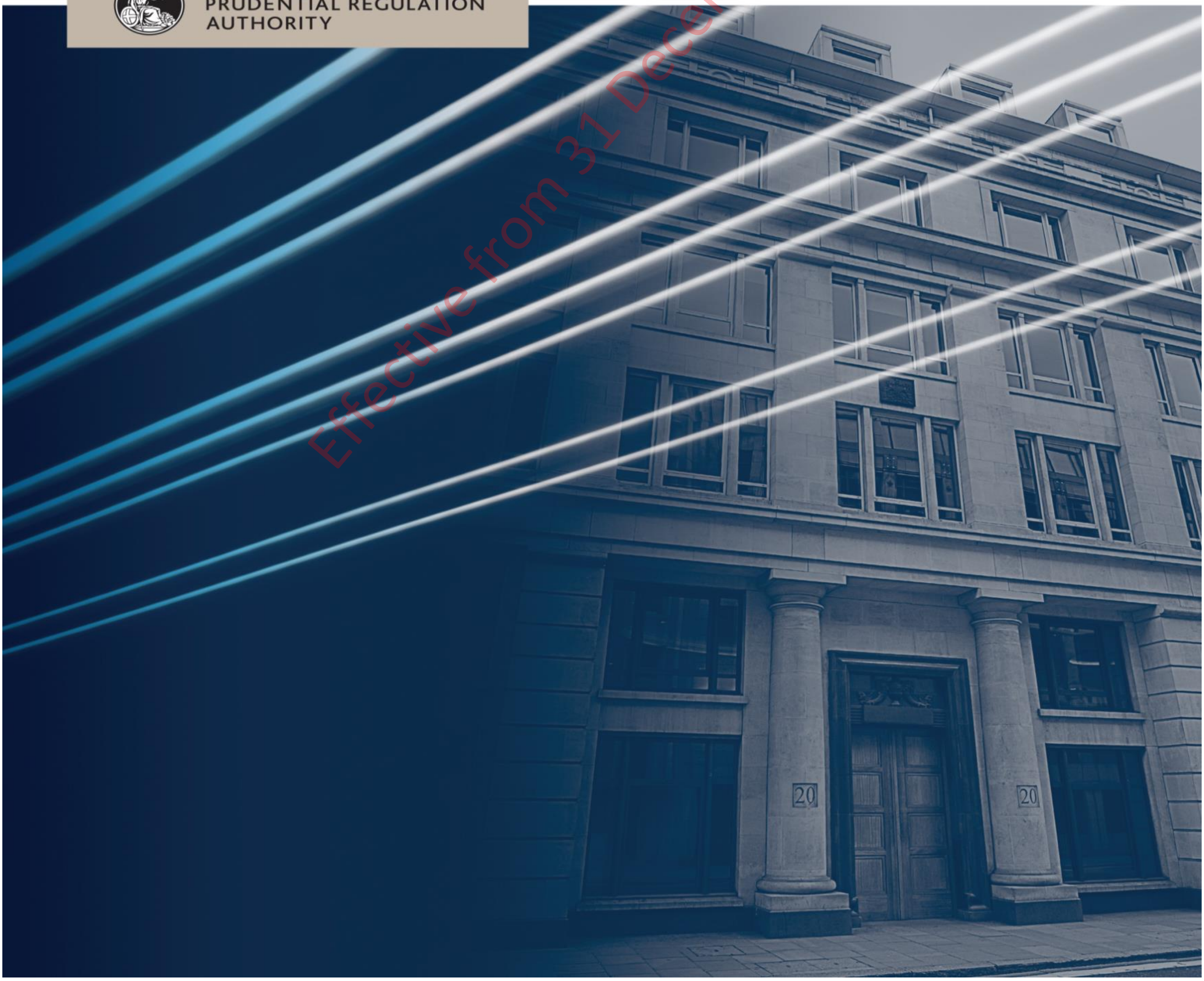
Supervisory Statement | SS17/15

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

February 2024

(Updating November 2016)

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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Contents

1 Introduction

1.1 This supervisory statement is of interest to all UK Solvency II firms and to the Society of Lloyd's, its members and managing agents. In particular, it is relevant to firms that are considering applying for, or that have been granted permission to use, either the transitional measure on the risk-free interest rate or the transitional measure on technical provisions ('TMTP').

1.2 It sets out the expectations for the use of these transitional measures, as specified in Transitional Measures 10 and the Transitional Measures on Technical Provisions Part of Prudential Regulation Authority (PRA) Rulebook.

1.3 This statement should be read in conjunction with chapters 10 and 12 of the Transitional Measures Part, the Transitional Measures on Technical Provisions Part , any other rules relevant to Solvency II firms, the Solvency 2 Regulations (2015/575),[1] the statement of policy (SoP) 'Permissions for transitional measures on technical provisions and risk-free interest rates',[2] and the PRA's insurance approach document.[3]

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 http://www.legislation.gov.uk/uksi/2015/575/contents/made.
2 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2023/june/cp1223app4.pdf.
3 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).[4]

3 Transitional measure on technical provisions

3.1 Under Solvency II, firms may apply to the PRA for permission to apply TMTP. This chapter sets out the PRA's expectations of the calculation of TMTP and for insurance business transfers and 100% reinsurance transactions[5] involving TMTP.

3.2 Deleted.

Calculation of TMTP

3.3 Deleted.

3.4 Deleted.

3.5 Deleted.

3.6 Deleted.

3.6A Firms that use the methodology set out in Transitional Measures on Technical Provisions 5 (the 'TMTP method') are required to perform the one-off 'base TMTP' calculation as set out in Transitional Measures on Technical Provisions 4.2(2). When performing the 'base TMTP' calculation, the PRA does not expect firms to reflect in the amount of the TMTP both the actual run off of insurance liabilities since the last calculation and the 1/16th linear deduction (i.e. a 'double run-off' effect). Firms should utilise their agreed methodology that was used at the last recalculation of TMTP prior to 31 December 2024, for avoiding this effect when performing the 'base TMTP' calculation.

3.6B In Transitional Measures on Technical Provisions 4.2(1) TMTP method firms can designate specific obligations that are matching adjustment ('MA')-eligible at the point of assessment for the purposes of calculating the dynamic portion, when applying the TMTP method for the first time. To provide additional flexibility, applicable firms can elect to designate only some or none of the aforementioned MA-eligible obligations for the purpose of calculating the dynamic portion.. For avoidance of doubt, all other business that is not designated for the dynamic portion must be used to calculate the non-dynamic portion, and firms are not required to calculate the dynamic portion if no business has been designated to it.

3.6C TMTP method firms are required to calculate TMTP at an overall firm level, in accordance with Transitional Measures on Technical Provisions 5. However, for internal management purposes, firms may choose to allocate its TMTP across different groups of liabilities (e.g.

4 See Transitional Measures 10.5(1) in the PRA Rulebook.
5 A 100% reinsurance contract is one which transfers to the reinsurer a 100% share of the ceding firm's risk under the reinsured contracts of insurance.

different ring fenced funds) provided that the overall TMTP calculation for the firm remains in accordance with the rules.

3.6D In Transitional Measures on Technical Provisions 5.1-5.2, “reporting period” refers to the reporting periods in which the firm is required to report its TMTP to the PRA in accordance with the Reporting Part of the PRA Rulebook, subject to any waivers. For internal management purposes, firms can calculate TMTP on a more frequent basis if preferred.

3.6E For the TMTP method when calculating the projected risk margin portion and dynamic portion as set out in Transitional Measures on Technical Provisions 5.2, the Chief Actuary may select appropriate methodologies consistent with the calculation of Technical Provisions and the principles set out in Article 56 of the Commission Delegated Regulations 2015/35.[6]

Insurance Business Transfers and Reinsured Business

3.7 Deleted.

3.7A Firms that use the TMTP method are required by Transitional Measures on Technical Provisions 6 to make an update to their TMTP methodology following a ‘transfer event’ which has resulted in a change in the firm’s technical provisions to which the TMTP relates. They are also permitted to make revisions to the business designated to the dynamic portion in order to designate acquired business that is MA-eligible in respect of that firm.. Transfer events are: 1) transfer of business either under Part VII of Financial Services and Markets Act 2000 (FSMA) or the Friendly Societies Act 1992; 2) the transfer of risk under a 100% reinsurance contract; 3) an amendment to an existing 100% reinsurance contract if there has been a change to the volume of risk to which the reinsurer is exposed; and 4) cancellation, commutation, termination or expiration of an 100% reinsurance contract. Such an update would only be permitted if the business that has been transferred or ceded was subject to TMTP prior to the transfer. The PRA expects this update to be based on figures at the effective date of the transfer or transaction.[7]

3.7B The PRA expects that the update described above should result in ‘Z_A’, continuing to represent the risk margin portion of the total TMTP post- transfer as a percentage of the risk margin on the underlying business post- transfer, as the PRA considers this an assumption underlying TMTP. For the purpose of determining how this ratio has changed due to a transfer event, the PRA expects a firm to use amounts equivalent to the risk margin portion of ‘transferred TMTP’ as calculated by the transferor or cedant (as relevant) and the risk margin on the technical provisions to which the TMTP permission relates as at the effective date.

3.7C The PRA expects that the update required by Transitional Measures on Technical Provisions 6 should result in ‘Z_B’, representing the dynamic portion of the total TMTP post transfer as a percentage of the dynamic BEL on the underlying business post transfer subject to any adjustment referred to in 3.7E below. For the purpose of determining how this ratio has changed due to a transfer event:

- if a firm does not revise the transferor or cedant’s designation of business used to calculate the dynamic portion then the PRA expects a firm to use amounts equivalent to the dynamic portion of ‘transferred TMTP’ as calculated by the transferor or cedant

6 Please note this reference will be updated in due course.
7 The ‘transferred TMTP’ should be as calculated immediately prior to the effective date of the transfer or transaction.

(as relevant) and the dynamic portion of the underlying business as at the effective date.[8]

- if a firm revises the transferor or cedant's designation of business used to calculate the dynamic portion then the PRA expects the transferee or reinsurer to reflect the revised split of business between the dynamic and non-dynamic portions of TMTP. A firm can do this by adjusting the dynamic portion of 'transferred TMTP' proportionally to the revised split of BEL and calculating the revised dynamic portion of the underlying business as at the effective date.

3.7D The PRA expects that the update required by Transitional Measure on Technical Provisions 6 should result in 'C_0' continuing to represent the portion of non-dynamic business attributable to the total TMTP post transfer subject to any adjustment referred to in 3.7E. Firms should use their updated 'C_0' to calculate 'C_r' in the TMTP method. The PRA expects the transferee or reinsurer to use an amount equivalent to the amount of 'C_0' attributable to the transferred business as calculated by the transferor or cedant. As with 'Z_B', such amount should be adjusted to reflect any revised split of business between the dynamic and non-dynamic portions. A firm can do this by adjusting the non-dynamic portion of 'transferred TMTP' proportionally to the revised split of BEL.

3.7E Firms must ensure that Transitional Measures on Technical Provisions 6.2 is adhered to, unless they have been granted a waiver or modification as set out in 3.3 of the SoP 'Permissions for transitional measures on technical provisions and risk-free interest rates'. The PRA expects this can be achieved by adjusting the value for 'Z_B' or 'C_0'.

3.8 Deleted.

3.8A Where a firm that has permission to use their TMTP methodology as at the date of their last recalculation prior to the 31 December 2024 (the 'legacy approach') is transferring business to a TMTP method firm the requirements in Chapter 6 apply to the TMTP method firm, the PRA expects the transferee to update 'Z_A', 'Z_B' and 'C_0' based on the transferor's TMTP immediately prior to the effective date of the transfer or transaction. The transferee will need to designate MA-eligible business for the purpose of calculating the dynamic portion. The transferor, should then split the TMTP into the risk margin portion of transferred TMTP, the dynamic portion of transferred TMTP based on the transferee's designation and the amount of the transferred TMTP attributable to the non-dynamic portion The transferee should then update 'Z_A', 'Z_B' and C_0' in accordance with 3.7B-3.7E above.

3.9 Deleted.

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

This section has been deleted.

Scope and granularity of application of the transitional measure

3.14 As set out in Transitional Measures on Technical Provisions 2.4 the application of TMTP is limited to business that was subject to a TMTP permission at 31 December 2024. .

3.15 Deleted.

3.16 For legacy approach firms, the PRA expects that the only limitations on the level of granularity chosen for the scope of the deduction are that:

(i) An Homogeneous Risk Group (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

This section has been deleted.

Review of Individual Capital Guidance

This section has been deleted.

4 Ongoing supervision of the TMTP

Limiting the amount of the transitional measure in future years

This section has been deleted.

Recalculations of the transitional deduction

4.2 Deleted.

Amount of TMTP applied and disclosed by a firm

4.2A For all firms with a TMTP permission there is a requirement that the amount of the transitional deduction to be applied by a firm is to be between zero and a maximum amount.[9] If a decision is taken by such a firm to apply less than the maximum amount, the PRA expects the firm to include both the maximum amount and actual TMTP amount in the notes to market disclosures, and to share this information with its supervision team. The firm should maintain a transparent approach to determining the amount of TMTP benefit it is applying. The PRA expects this approach to be followed consistently by firms within all Solvency II reporting including for Quarterly Reporting Templates (QRTs). This approach should also be reflected within a firm's ORSA and risk management framework.

4.2B The PRA expects that a firm's disclosure of its solvency ratio will include an allowance for TMTP no greater than the maximum amount at the relevant reporting date.

Criteria for legacy approach firms

4.2C As set out in paragraph 5.3 of SoP 'Permissions for transitional measures on technical provisions and risk-free interest rates', legacy approach firms were required to meet certain

9 The maximum amount is the maximum number derived from the TMTP method in Transitional Measures on Technical Provisions 5 or the legacy approach outlined in the relevant firm's permission.

criteria prior to the PRA varying their permission to apply the approach. The PRA expects that legacy approach firms provide evidence that they continue to meet the criteria set out in paragraph 5.3 of SoP 'Permissions for transitional measures on technical provisions and risk-free interest rates' on an annual basis as part of the ORSA.

Consistency of Solvency I and Solvency II bases for legacy approach firms

4.2D The underlying assumptions of both Solvency I Pillar 2 and Solvency II technical provisions are on a best estimate basis. Both Solvency II and INSPRU 7[10] include provision for the best estimate basis to be based on up-to-date and credible information, and to reflect market conditions. Legacy approach firms are expected to review the best estimate assumptions at regular intervals, and must make updates that reflect changes in market conditions and/or demographic assumptions.

4.2E Where changes are made to best estimate assumptions which are inputs to both the Solvency I and Solvency II bases, and these changes have a material impact on the level of technical provisions, the PRA expects that the assumption changes should be made consistently within the Solvency I Pillar 2 and Solvency II best estimate bases. The PRA's view is that the impact of such an assumption change should not be included within the TMTP benefit as the change reflects market conditions and/or demographic assumptions, rather than being introduced by Solvency II requirements themselves. The need to maintain consistency is an ongoing expectation, and applies whenever TMTP is calculated.

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

5.1 The TMTP cannot be applied after 1 January 2032.[11]

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.[12]

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.

Run-off of TMTP compared with technical provisions

5.5 Firms' underlying business may run off faster or slower than the transitional period 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.

10 As defined in Transitional Measures on Technical Provisions 1.2.
11 Transitional Measures on Technical Provisions 2.3
12 Transitional Measures on Technical Provisions 7.1(3) .

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

- the projected risk profile; 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). The PRA also expects that firms consider whether there are any risks to meeting their solvency risk appetite[13] over the medium term due to TMTP run-off. The PRA expects firms to share this analysis with their supervisors annually.

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.

5.8A The PRA expects that where a TMTP method firm has been granted a waiver or modification as set out in paragraph 3.2 of the SoP, it should document its amortisation approach in its ORSA.

6 The approval process

This chapter has been deleted.

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 Chief Actuary of the firm, as part of their overall responsibility for the actuarial function. The PRA expects that the responsibilities of the actuarial function in the Conditions Governing Business 6.1(b) and (e) should therefore include assurance around the calculation of TMTP where applicable. As part of annual year-end reporting, the Chief Actuary is only expected to confirm that the TMTP has been calculated in line with the methodology for calculating TMTP that the firm has permission to use and has been appropriately reduced in line with the applicable requirements.

8 Interaction with other Solvency II approvals and contingency planning

This chapter has been deleted.

13 The risk appetite used should be that for levels of capital as set out in their risk appetite statement as expected by paragraph 2.3 of SS4/18.

Appendix – SS17/15 updates

SS17/15[14] was originally published on 20 March 2015 following CP3/15, 'Solvency II: transitional measures and the treatment of participations'.[15]

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

28 February 2024

This SS was updated following publication of PS2/24 – Review of Solvency II: Adapting to the UK insurance market[16] which contained final policy that introduced new rules, a new SoP, deleted SS6/16, and material updates to this SS. The finalised policy and rules make significant changes to the TMTP framework including introducing a simplified default method for calculating TMTP, removing the financial resource requirement ('FRR') test, and removing the requirement for firms to seek PRA permission for a recalculation. These changes have materially changed the PRA's expectations set out in this SS. The amendments are detailed further below:

- paragraph 3.1-3.6E: paragraphs deleted and additional paragraphs added to reflect the PRA's expectations for how the TMTP should be calculated under the revised approaches set out in the PRA rules and SoP;
- paragraphs 3.7-3.10: paragraphs deleted and new paragraphs added to reflect the PRA's expectations for how insurance business transfers and 100% reinsurance transactions involving TMTP should work under the TMTP rules;
- paragraphs 3.11-3.13: paragraphs deleted, as reinsurance is now covered in an earlier section;
- paragraph 3.14: paragraph updated to reflect revised rules;
- paragraph 3.15: deleted as no longer relevant under the revised approach to TMTP permission applications as set out in the SoP;
- paragraph 3.16: updated to reflect that these expectations will now only be applicable to legacy approach firms;
- paragraphs 3.17-4.1: deleted as no longer relevant under the revised policy framework;
- paragraph 4.2A-4.2B: updated text to reflect expectations that were in the now-deleted SS6/16;
- paragraph 4.2C-4.2E: updated text to reflect PRA's expectation of firms using legacy approach;
- paragraph 5.1: text updated for clarity;

14 March 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss1715.aspx.
15 January 2015; www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp315.aspx.
16 www.bankofengland.co.uk/prudential-regulation/publication/2024/february/review-of-solvency-ii-adapting-to-the-uk-insurance-market-policy-statement.

- paragraphs 5.5-5.6: text updated for clarity and to remove references to initial TMTP applications, which are no longer a relevant benchmark for firms;
- paragraph 5.7: text updated to set out PRA expectation of firms considering whether there are risks to meeting their solvency risk appetite over the medium term due to TMTP run-off;
- paragraph 5.8A: added expectation for firms to document their amortisation approach in their ORSA, if they have been granted a waiver or modification.
- chapter 6: deleted as content now covered in the SoP;
- paragraph 7.1: text updated to reflect that TMTP should be overseen by the Chief Actuary rather than the audit committee of a firm and to remove references to recalculation requirements;
- chapter 8: deleted as content now covered in the SoP; and
- throughout the SS: references to legislation and rules that are no longer applicable have been removed or amended.

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[17] 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;

17 Available at www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss616.aspx.

- 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.