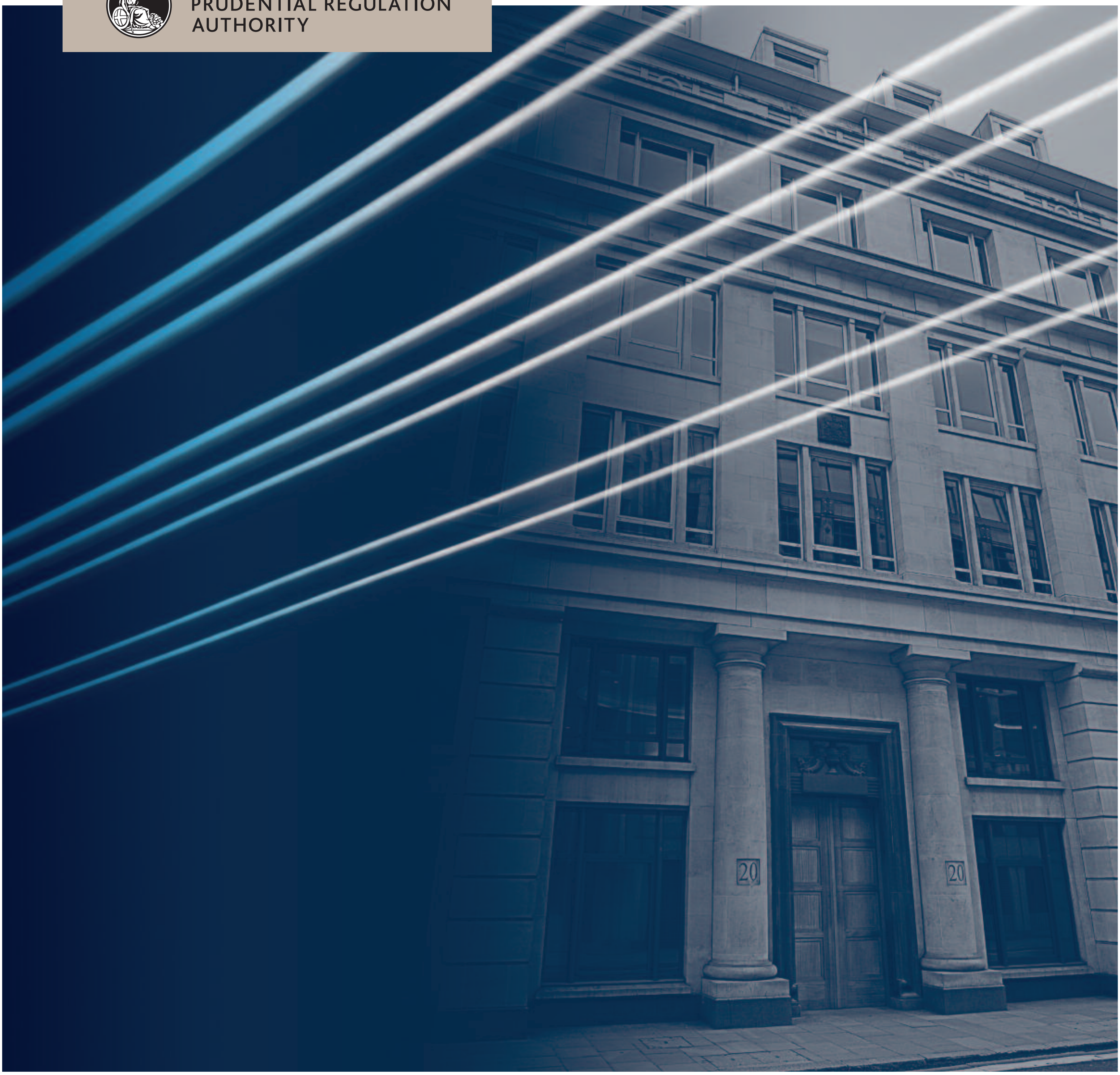
Supervisory Statement | SS17/15

Appendix 2.17

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

March 2015

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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

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1 Introduction

1.1 This supervisory statement is of interest to all UK Solvency II firms 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 chapters 10 and 11 of the Solvency II Firms: Transitional Measures Part of the Prudential Regulation Authority (PRA) Rulebook.

1.3 This statement should be read in conjunction with those chapters of the Solvency II Firms: Transitional Measures Part of the PRA Rulebook, the rules in the rest of the Solvency II Firms section of the PRA Rulebook, the Solvency II Regulations and with European Insurance and Occupational Pensions Authority (EIOPA) Level 3 Guidelines.

1.4 This statement expands on the PRA's general approach as set out in the PRA's approach to insurance supervision.(1) 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.

1.5 This statement has been subject to public consultation(2) and reflects the feedback that was received by the PRA.

1.6 The PRA believes that the benefits associated with this supervisory statement are proportionate to the costs. By providing further clarity to firms on the expectations regarding the calculation methodology of the risk-free rate and technical provisions transitionals, the PRA seeks to ensure that firms have sufficient time to meet any incremental capital compliance costs resulting from Solvency II. This would avoid the need for firms to take short-term capital raising and/or other management actions that may not be optimal for long-term policyholder protection.

1.7 The main cost associated with the proposals is that firms using the transitional measures will have lower financial resources than would be required by immediate introduction of the full Solvency II regime. Existing policyholders will thus temporarily have a lower level of protection than would be the case under the full Solvency II requirements, but not below the level of our current requirements.

1.8 The PRA has also had regard to its secondary competition objective and considers that the content of this statement provides a framework for competition that maintains current levels of policyholder protection, while allowing incumbents and new entrants to compete for new business on an equivalent regulatory basis.

1.9 The proposals in this statement are not expected to have any direct or indirect discriminatory impact under existing UK law.

2 Transitional measure on the risk-free interest rate

Calculation of the single interest rate

2.1 In meeting the requirements of Solvency II Firms: 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 INSPRU 1. In their applications, firms are expected to explain and justify the method used.

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 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).(3)

3 Transitional measure on technical provisions

3.1 Under Solvency II, firms may apply to the PRA for approval to make a transitional deduction from technical provisions (a 'transitional deduction'). This chapter sets out the PRA's

(1) Available at www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf.
(2) *PRA Consultation Paper CP3/15*, 'Solvency II: transitional measures and the treatment of participations', January 2015; www.bankofengland.co.uk/pra/Documents/publications/cp/2015/cp315.pdf.
(3) See Transitional Measures 10.5(1) in the Transitional Measures Part of the PRA Rulebook.

expectations of the calculation methodology that firms should use for the transitional deduction.

3.2 The scope of this chapter is limited to the calculations a firm must perform to apply the transitional deduction. Nothing in this supervisory statement should be taken to have any bearing on the pre-Solvency II technical provisions that a firm currently calculates for regulatory or reporting purposes. The PRA does not expect any firm to recalculate or restate the technical provisions it uses for pre-Solvency II regulatory purposes as a result of this statement.

Calculation of the transitional deduction before application of the limit

3.3 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 Pillar 1 technical provisions as set out in Chapter 1 of the Prudential Sourcebook for Insurers (INSPRU 1).

3.4 When calculating the 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 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 current 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 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.

Scope and granularity of application of the transitional deduction

3.7 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; that is, the HRGs are those that are used to segment the technical provisions under Solvency II.

3.8 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 Pillar 2 insurance liabilities calculation, and to reliably calculate Pillar 2 insurance liabilities in respect of these HRGs; 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 deduction

3.9 The PRA's view is that the 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

3.10 The PRA is aware that at 31 December 2015, some firms will not have 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 feel 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 ICA that have altered since ICG was last set.

3.11 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 transitional deduction

Limiting the amount of the transitional deduction 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 at outset, 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 The PRA may request that a firm carries out a recalculation of the transitional deduction if the firm's risk profile has materially changed since the approval was initially granted (or since the last time a recalculation was approved). Examples of risk profile changes that could trigger a recalculation would include:

- disposal of business written before 1 January 2016;
- material changes to the reinsurance programme;
- unexpected changes to the run-off pattern of the insurance obligations in scope of the transitional deduction;
- a change in the firm's use of either the matching adjustment or the volatility adjustment; and
- a change in the way that the firm calculates its SCR (eg upon approval to use a full or partial Internal Model).

These are examples only and the PRA would consider the need for a recalculation on a case-by-case basis.

5 The approval process

5.1 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 from 1 April 2015. For planning purposes, the PRA asks firms to notify their usual supervisory contacts at the earliest opportunity if they intend to make an application.

5.2 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.

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

5.4 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 during the next twelve months.

5.5 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.

6 Interaction with other Solvency II approvals and contingency planning

6.1 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.

6.2 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.