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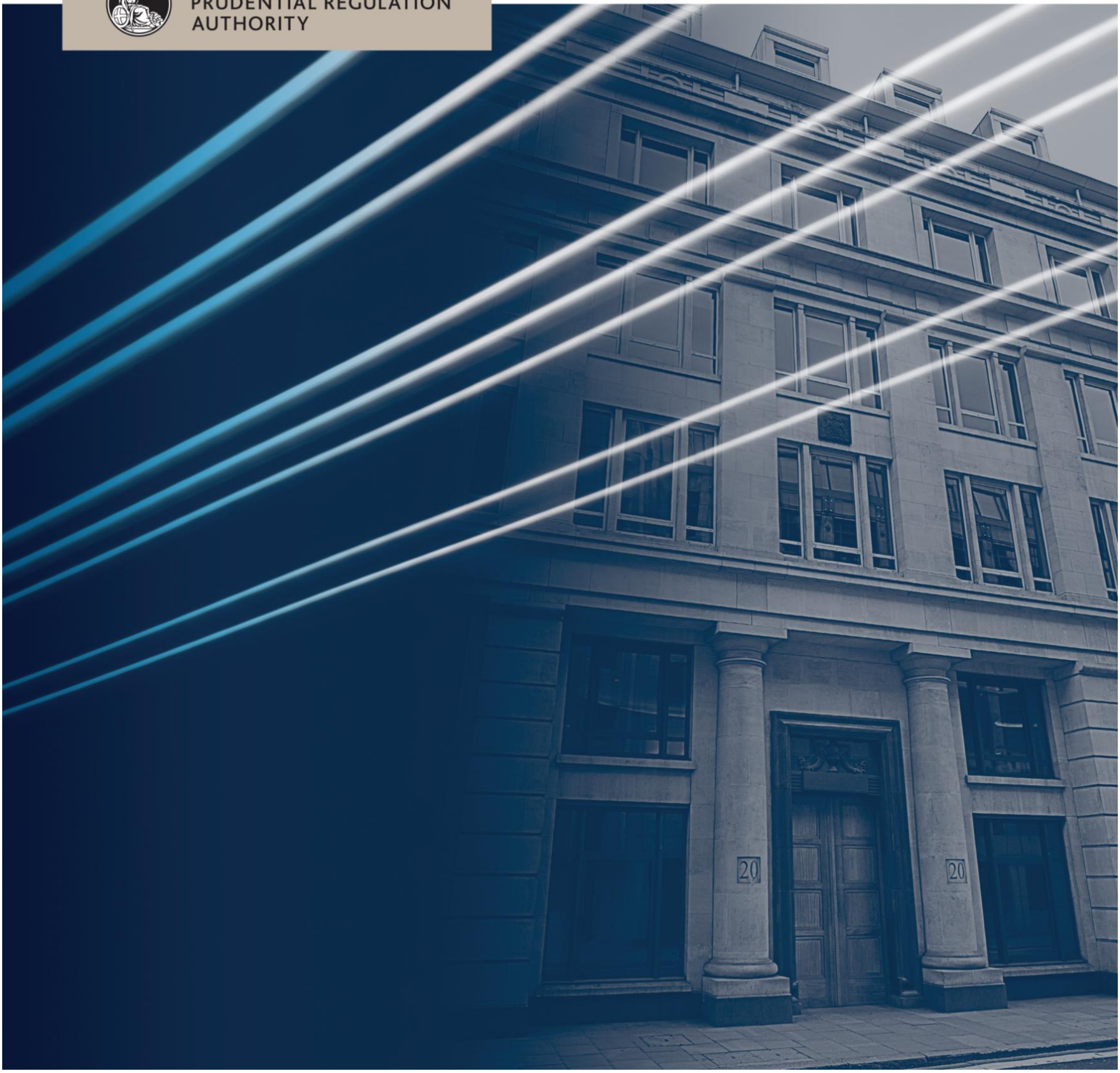
Supervisory Statement | SS6/16

Recalculation of the ‘transitional measure on technical provisions’ under Solvency II

May 2016

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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1 Introduction

1.1 The Solvency II Directive allows for a recalculation of the transitional measure on technical provisions (TMTP)[1] every 24 months, or more frequently where the risk profile of the firm has materially changed. These Directive provisions have been transposed by HM Treasury's Solvency 2 Regulations 2015 (2015/575) (see Regulation 54).[2] The purpose of this supervisory statement is to provide clarity with respect to the PRA's expectations, and proposed process, for recalculations of the TMTP.

1.2 This statement is of interest to all UK insurance firms within the scope of Solvency II and to the Society of Lloyd's. It is particularly relevant to firms that have been granted approval to use the TMTP, or those that have been considering applying to use this transitional measure.

1.3 In particular, this statement sets out the PRA's expectations and proposed process for:

- requesting that a firm carry out a recalculation of the transitional measure; and
- assessing a firm's application for a recalculation on the basis of a material change in risk profile.

1.4 This statement expands on the PRA's general approach as set out in its insurance approach document.[3] By clearly and consistently communicating 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.

1.5 This statement has been subject to public consultation[4] and reflects the feedback that was received by the PRA.

2 Recalculations of the transitional measure

Recalculation at 24 month intervals

2.1 The Solvency II Directive allows for a recalculation of the transitional measure every 24 months without further conditions either on request by a firm or on the initiative of the supervisory authority. The PRA expects firms to carry out this recalculation at the end of every 24 months following the commencement of the transitional measure on 1 January 2016. Firms will be expected to update the calculation of this measure as at the last working day of the years 2017, 2019, 2021, etc. This will help to promote a continuing alignment between the relief afforded by the TMTP and those elements of the technical provisions for which it was designed.

1 Previously referred to as the transitional deduction from technical provisions.
2 March 2015: www.legislation.gov.uk/uksi/2015/575/pdfs/uksi_20150575_en.pdf.
3 The Prudential Regulation Authority's approach to insurance supervision', March 2016 available at: www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.
4 PRA Consultation Paper CP15/16, 'Recalculation of the 'transitional measure on technical provisions' under Solvency II', April 2016: www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp1516.aspx.

Recalculation at an earlier date arising from change in risk profile

2.2 The PRA may request that a firm carry out a recalculation of the transitional measure at any time if the firm's risk profile has materially changed since the approval was initially granted (or since the last time a recalculation was approved). Solvency II also makes provision for a firm itself to apply for approval to carry out a recalculation in similar circumstances. Should a firm wish to make use of this provision, it will need to present sufficient evidence to the PRA of a material change in risk profile.

Circumstances giving rise to recalculation because of a material change in risk profile

2.3 In the PRA's view a variety of circumstances may give rise to a material change in risk profile. Risk profile changes that may trigger a recalculation include but are not limited to the following examples:

- acquisition or disposal of business priced and written before 1 January 2016;
- material changes to the reinsurance programme for business priced and written before 1 January 2016;[1]
- unexpected changes to the run-off pattern of the insurance obligations in scope of the transitional measure;
- a change in the firm's use of either the matching adjustment or the volatility adjustment; or
- changes in operating conditions, including in interest rates or market prices of other financial assets leading to revised market risk exposures, or crystallisation of an insurance risk exposure, eg a change in projected mortality experience.

2.4 The points set out in paragraph 2.3 are only examples and the PRA would consider the need for a recalculation on a case-by-case basis.

2.5 The PRA intends to examine external market-wide events, such as significant changes in the risk-free rate published by the European Insurance and Occupational Pensions Authority (EIOPA), every six months to determine whether changes in market conditions are likely to have created a material change in firms' risk profiles. Firms may then be invited to make an application for a recalculation at that point. However, applications for a recalculation will still be assessed individually, on the basis of each firm's justification of how the market-wide event has caused a material change to its risk profile. The PRA will take into account the same factors, and in particular those set out in paragraph 2.9 below, in deciding whether to invite firms to make an application for a recalculation, and in making an assessment of a firm's justification of a material change in risk profile. The PRA's review of external market-wide events does not preclude firms from making an application at any point: it is intended to facilitate an efficient approval process at regular intervals.

2.6 The PRA expects firms to develop their own policy for recalculations of the transitional measure. This should set out, for example, the triggers for the firm to apply for a recalculation, which the PRA expects to be symmetrical, ie taking into account the event of an increase and a

1 Reinsurance will be considered on a case-by-case basis. Further details on the PRA's expectations in relation to reinsured business are set out in PRA Consultation Paper CP20/16: 'Solvency II: consolidation of Directors' letters', May 2016: www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp2016.aspx.

decrease in the transitional measure. The policy should also set out how the design and calibration of the triggers are related to the firm's risk profile.

2.7 When developing this policy, firms should also consider the other actions that would be triggered by a material change in risk profile. For example, a firm is likely to need to update its own risk and solvency assessment and, where necessary, its internal model to reflect this change.

2.8 The PRA notes that volatility in solvency coverage can arise from a number of sources, which include but are not restricted to those that would be offset by a TMTP recalculation. The PRA still expects firms to ensure that their asset-liability management policies are appropriate to manage solvency coverage within their stated risk appetite.

The PRA's assessment of a material change in risk profile

2.9 Where changes in operating conditions give rise to a potential change in risk profile the PRA will make an assessment of the materiality of that change, which will take into account the:

(i) change in the risk-free rate since the date of the last recalculation;

(ii) impact on a firm's solvency coverage ratio; and

(iii) impact of a recalculation on a firm's solvency coverage ratio.

2.10 For changes in risk profile that result from a change in operating conditions, all of the above will be relevant. Where the change in risk profile potentially results from events other than changes in operating conditions, for example, as a result of the other circumstances set out in paragraph 2.3, then only (ii) and (iii) will be relevant.

2.11 The PRA expects that with respect to (i), a change of 50bps or more in the 10-year risk-free rate is likely to be the point at which a material change could reasonably be expected to occur. In reaching this judgement, the PRA gave consideration to the historical distribution of six-monthly risk-free rate changes. It is the PRA's view that sustained changes in risk-free rates in excess of this threshold are likely to represent a material change to the current interest rate conditions. A sustained change is likely to be either a change that has persisted for a significant period of time or one that has been driven by factors that are likely to persist for a significant period of time. In reaching this judgement, the PRA considered evidence on interest rate conditions prevailing since 2009 but the PRA's approach would be reviewed should there be a material and sustained change in observed interest rate volatility.

2.12 The PRA has indicated that changes to risk-free rates will be particularly relevant as such changes are likely to result in variation in the risk margin. The risk margin is a key component of technical provisions that the TMTP is off-setting, and affects all firms. Severe and sustained moves in other market risk factors, such as changes in credit spreads, could also be relevant in considering the circumstances set out in paragraph 2.9. In such cases a firm may apply to the PRA for approval to recalculate its TMTP. However, a change in credit spreads is not likely to lead to a material change in risk profile for all firms as this will depend on the asset holdings of each firm.

2.13 For a change in risk profile to be considered as material, the PRA will consider whether there has been a material increase or decrease in a firm's solvency coverage ratio at the legal entity level. The degree of change that is considered material will depend on individual firms' risk profiles.

2.14 With respect to criterion (iii) of paragraph 2.9, the PRA would not generally expect firms to apply for a recalculation if the resulting increase or decrease in solvency coverage ratio at the legal entity level were less than 5 percentage points. If the resulting change were smaller than this, the PRA expects that firms would be unlikely to apply for a recalculation, given the other actions that this would likely trigger.

2.15 The PRA expects that firms will submit appropriate evidence of a material change in risk profile when applying to carry out a recalculation, taking into account the PRA's views on materiality set out in paragraph 2.9. For example, with regards to (ii) of paragraph 2.9, the PRA expects firms to explain the materiality of the change in a firm's solvency ratio by comparison with the expected frequency and likelihood of such a change occurring (ie in relation to the firm's probability distribution of changes in solvency ratios and changes in own funds, as such distributions vary between firms). It is the PRA's view that the expected frequency and likelihood of changes occurring in solvency ratios and own funds are key indicators in determining what constitutes a material change in risk profile.

Proportionate approach to carrying out a recalculation

2.16 The PRA will take a proportionate approach with respect to firms' recalculations of TMTPs. In particular, the PRA expects that the level of detail in a firm's calculation methodology will be proportionate and firms should discuss their proposed methodology with their supervisors. The financial resource requirement test will still apply and firms will be expected to demonstrate robust internal governance to support any conclusion that the test is still met.

2.17 The PRA considers that when undertaking a recalculation, the Solvency II Directive does not explicitly require firms to reflect in the amount of the transitional deduction the actual run-off of insurance liabilities since the last (re)calculation and the 1/16th linear deduction (ie a 'double run-off' effect). Firms should speak to their supervisors about this when discussing their proposed methodology for recalculations.

2.18 The PRA recognises that it may be burdensome for firms that have recalculated their transitional measure, as a result of a material change in risk profile, shortly before the end of a 24 month period to then be expected to carry out another regular recalculation, if the resulting change would be minimal. In such cases, the PRA is likely to take a proportionate approach and not require the firm to carry out this recalculation. However, the PRA expects that such a firm would only apply for further recalculations as a result of a material change in risk profile, until the last working day in December of the next 24 month period.