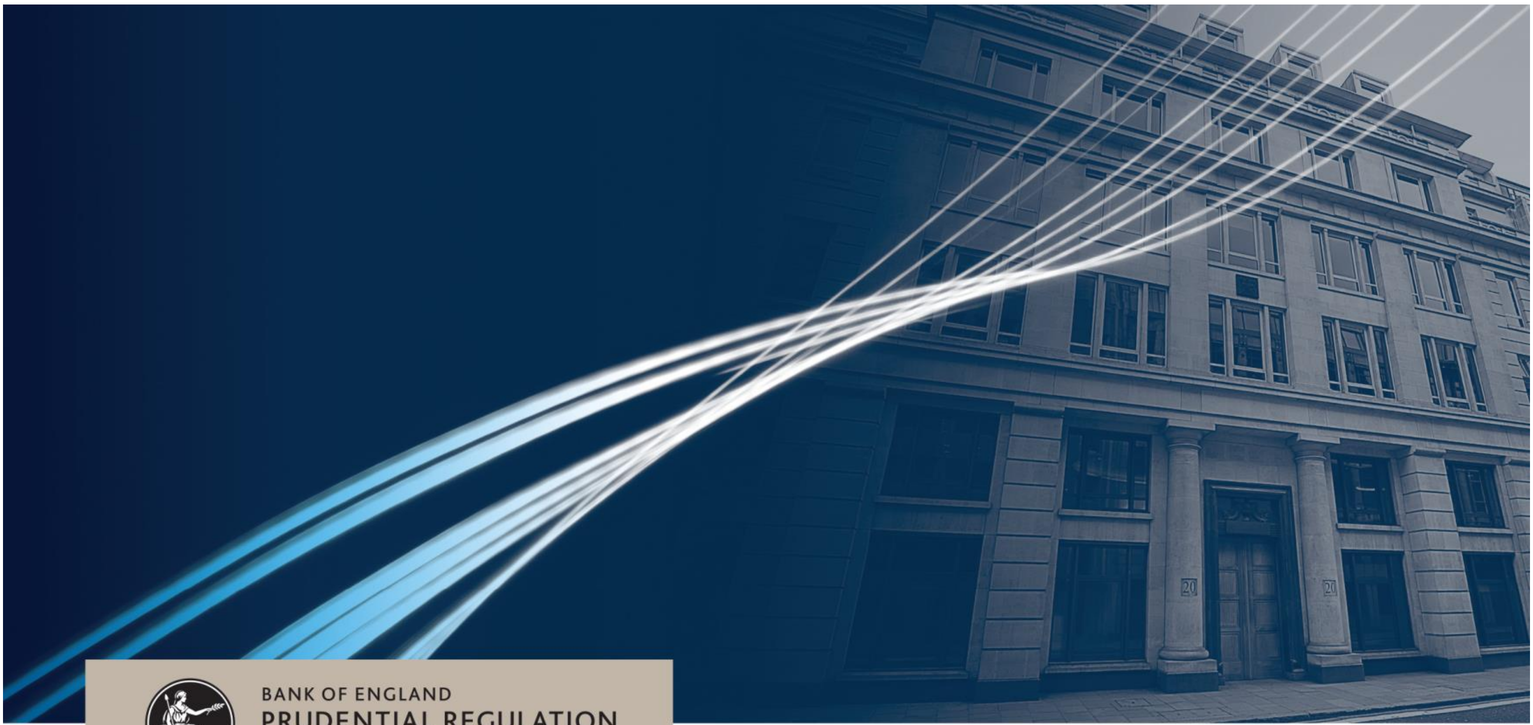

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP15/16

Recalculation of the 'transitional measure on technical provisions' under Solvency II

April 2016

Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

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Responses are requested by Friday 13 May 2016.

Please address any comments or enquiries to:
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1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) proposes a supervisory statement that sets out the PRA's expectations for the recalculation of the transitional measure on technical provisions (TMTP).

1.2 This CP is of interest to all UK insurance firms within the scope of Solvency II and to the Society of Lloyd's. In particular, it is relevant to firms that have been granted approval to use, or have been considering applying for, the TMTP.

Background

1.3 The Solvency II Directive allows firms to apply to their supervisory authority for approval to use the TMTP.[1] Under the Directive, recalculation is permitted, at the initiation of either the firm or the PRA:

(i) every 24 months; or

(ii) more frequently where the risk profile of the firm has materially changed.

1.4 The purpose of the draft supervisory statement is to provide clarity on the PRA's expectations for, and process applicable to, recalculations of this transitional measure. It should be read in conjunction with 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 2 Regulations 2015 (2015/575)[2] and with the European Insurance and Occupational Pensions Authority (EIOPA) Level 3 Guidelines.[3] The draft statement should also be read alongside Supervisory Statement 17/15 'Solvency II: transitional measures on risk-free interest rates and technical provisions'[4] and the 'Management of the Run-Off of TDTP relief in future years' section of the Directors' letter published on 16 September 2015.[5]

Statutory objectives

1.5 The proposals are compatible with the PRA's statutory objectives under the Financial Services and Markets Act 2000 (FSMA): to promote the safety and soundness of PRA-authorised firms;[6] and in the context of insurance, to contribute to policyholder protection.[7] For example, a symmetrical regime, whereby the transitional deduction is recalculated when it gets smaller as well as when it gets larger, will contribute to policyholder protection by ensuring that the incentives for firms to manage their true economic risks are retained.

1.6 When discharging its general rule-making function, the PRA is required, so far as is reasonably possible, to facilitate effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.[8] The PRA considers that the proposed supervisory statement could help to avoid adverse impacts on competition. For example, the PRA's expectation that firms carry out a recalculation at the end of every 24

1 Article 308d of the Solvency II Directive.
2 March 2015; http://www.legislation.gov.uk/uksi/2015/575/pdfs/uksi_20150575_en.pdf.
3 February 2015; https://eiopa.europa.eu/Publications/Guidelines/TP_Final_document_EN.pdf.
4 PRA Supervisory Statement 17/15, 'Solvency II: transitional measures on risk-free interest rates and technical provisions', March 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss1715.aspx.
5 September 2015; www.bankofengland.co.uk/pra/Documents/about/directorsletter16sep2015.pdf.
6 See s.2B(1) and s.2B(2) FSMA.
7 See s.2C FSMA.
8 See s.2H FSMA.

months will improve consistency, transparency and comparability of the use of this transitional measure.

1.7 The PRA has considered the impact of the proposals in the draft supervisory statement on firms and the PRA. The PRA believes that the proposals in the statement are compatible with its duty to use its resources effectively and does not expect the proposals in this statement to give rise to any significant costs for firms.

1.8 In making its rules and establishing its practices and procedures, the PRA must have regard to the Regulatory Principles as set out in the FSMA.[1] In particular, the draft statement sets out the PRA's expectations and process regarding the recalculation of TMTPs, ensuring that this process is as transparent as possible. The PRA may not act in an unlawfully discriminatory manner. It is required, under the Equalities Act 2010, to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies. The PRA does not consider that the proposed statement gives rise to any equality and diversity issues.

1.9 The PRA does not believe that the proposed statement will have an impact on mutuals that significantly differs from other firms.

Responses and next steps

1.10 This consultation closes on Friday 13 May 2016. The PRA invites feedback on the proposals set out in this consultation and will consider this feedback before issuing a final supervisory statement. Where possible, the PRA encourages the provision of supporting evidence alongside responses to this consultation. Please address any comments or enquiries to CP15_16@bankofengland.co.uk.

1 See s.2H and s.3B of FSMA.

Appendix: Draft supervisory statement – Recalculation of the transitional measure on technical provisions under Solvency II

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 HMT's Solvency 2 Regulations 2015 (2015/575) (see Regulation 54).[2] The purpose of this draft supervisory statement is to provide clarity with respect to the PRA's expectations, and proposed process, for recalculations of the TMTP.

1.2 This draft 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 draft 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.

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. For example, firms will be expected to update the calculation of this measure as at the first working day of the years 2018, 2020, 2022, etc.

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 firms 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 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:

- disposal of business priced and written before 1 January 2016;

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.

- material changes to the reinsurance programme for business priced and written before 1 January 2016;
- 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; and
- 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 These are examples only 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 risk profile. 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.

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 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 Notwithstanding the use of recalculation in the event of a material change in risk profile, the PRA still expects firms to ensure that their asset-liability management policies are appropriate to manage the 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 ten-year 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 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 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. In reaching this judgement, the PRA considered evidence on interest-rate conditions prevailing since 2009 but the PRA's approach would likely be reviewed should there be a material and sustained change in interest-rate volatility. Exceptionally severe moves in other market-risk factors could also be relevant in considering the circumstances in paragraph 2.9.

2.12 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. The degree of change that is considered material will be dependent on individual firms' risk profiles.

2.13 With respect to (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 was less than 5 percentage points. If the resulting change was smaller than this, the PRA expects that firms will be unlikely to apply for a recalculation, given the other actions that this would likely trigger.

2.14 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 distributions of changes in solvency ratios and changes in own funds, as such distributions vary between firms).