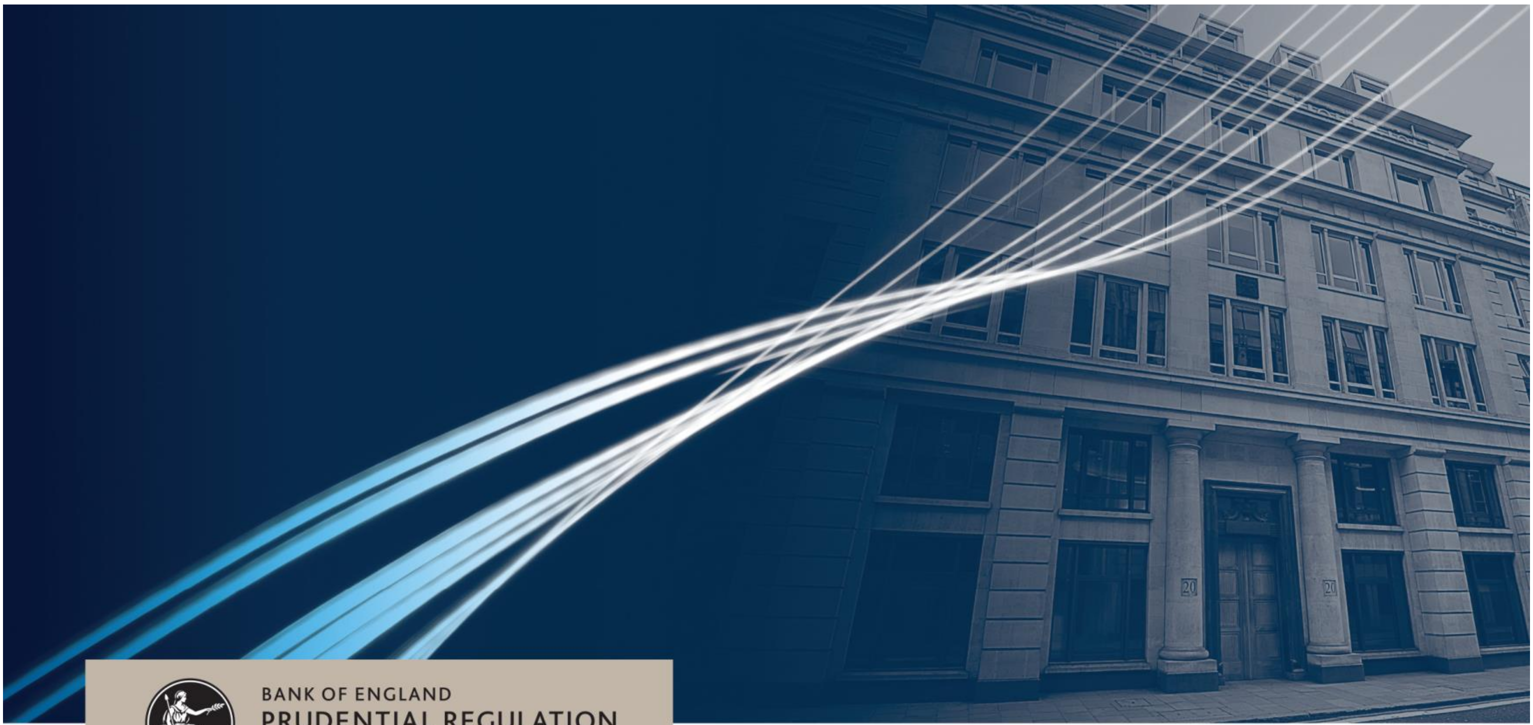

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP47/16

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

December 2016

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Responses are requested by Wednesday 15 March 2017.

Please address any comments or enquiries to:

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1 Overview

1.1 This consultation paper (CP) sets out the Prudential Regulation Authority's (PRA) proposed updates to Supervisory Statement (SS) 6/16 'Recalculation of the 'transitional measure on technical provisions' under Solvency II'.[1] The purpose of the proposal is to clarify the PRA's expectations for maintaining the calculation of the Transitional Measure on Technical Provisions ('TMTP') both at outset and over the transitional period.

1.2 This CP is relevant to life insurance and reinsurance companies using or intending to use TMTP.

1.3 The proposed updates to SS6/16 (Appendix 1) should be read in conjunction with:

- the Transitional Measures Part of the PRA Rulebook;
- the rules in the rest of the Solvency II Firms Sector of the PRA Rulebook;
- the Solvency 2 Regulations 2015 (2015/575);[2]
- the European Insurance and Occupational Pensions Authority (EIOPA) Level 3 Guidelines;[3] and
- SS17/15 'Solvency II: transitional measures on risk-free interest rates and technical provisions'.[4]

1.4 This consultation closes on Wednesday 15 March 2017. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP47_16@bankofengland.co.uk.

2 Proposals

2.1 The Solvency II Directive allows firms to apply to their supervisory authority for approval to use the TMTP. The TMTP mitigates changes to the calculation of technical provisions ('TPs') which have been introduced by Solvency II. The starting point for the calculation of the TMTP is a comparison of TPs calculated under Solvency I Pillar 2 (Individual Capital Adequacy Standards) and under Solvency II.

2.2 Over the lifetime of the Solvency II transitional relief from 2016 to 2032, it is anticipated that firms may need to make changes in their assumptions and/or methodology for the calculation of TPs. Not all these changes will relate solely to elements of the TPs where changes have been introduced by Solvency II, for example changes to assumptions may have been made to reflect up-to-date operating experience. This CP sets out the PRA's expectations as to how the Solvency I comparator used for the calculation of the TMTP should continue to be maintained over time. The PRA is proposing that changes in best estimate assumptions used to calculate Solvency II TPs should, where applicable, be reflected consistently in the Solvency I Pillar 1 and Pillar 2 bases.

1 May 2016; www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss616.aspx.
2 March 2015; 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 March 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss1715.aspx.

2.3 The PRA is also making proposals in respect of the:

- need for firms to analyse the material components and drivers of the TMTP benefit in order to facilitate better risk management, and
- role of firms' Audit Committees in ensuring that the TMTP claimed continues to meet the conditions for approval.

2.4 The proposals set out are not solely related to the recalculation of the transitional relief, and hence the title of the SS6/16 has been amended to reflect this. The following changes are proposed in the draft SS:

- the title of SS6/16, and paragraphs 1.1 and 1.3 updated to reflect the expanded scope of the SS;
- a new Chapter 2 has been included that sets out the PRA's expectations that firms should analyse the material components and drivers of TMTP relief;
- a new Chapter 3 has been included that sets out the PRA's expectations on how firms should keep Solvency I and Solvency II valuation bases consistent; and
- the original Chapter 2 has been renumbered as Chapter 4, with additional text added to clarify the PRA's expectations with respect to the use of approximate methodologies in calculating the amount of TMTP relief.

3 The PRA's statutory obligations

3.1 The PRA considers that the proposals set out in this CP are compatible with the PRA's statutory objectives under the Financial Services and Markets Act 2000 (FSMA).[1] The proposals would contribute to the PRA's general objective to promote the safety and soundness of firms and the PRA's insurance specific objective to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders, by ensuring that the appropriate amount of transitional relief is applied in the valuation of Own Funds. When determining the general policy and principles by reference to which it performs particular functions, the PRA is legally required, so far as is reasonably possible, to facilitate effective competition in the markets for services provided by PRA-authorised persons in carrying out regulated activities. The PRA does not consider that the proposal will hinder effective competition.

3.2 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 significant costs for firms.

3.3 In discharging its general functions the PRA must have regard to the regulatory principles as set out in the FSMA.[2] Of particular relevance to the proposals in this CP are the principles related to efficient use of resource and proportionality.

1 Sections 2B and 2C.
2 Sections 2H and 3B.

3.4 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.

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

Appendix 1: Draft amendments to Supervisory Statement 6/16 ‘Recalculation of the ‘transitional measure on technical provisions’ under Solvency II’

Underlining indicates new text and striking through indicates deleted text.

Supervisory Statement 6/16 ~~Recalculation~~ ‘Maintenance of the ‘transitional measure on technical provisions’ under Solvency II’

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 as to how the TMTP should be maintained over the transitional period and the proposed process for recalculations of the TMTP.

…

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

- how the calculation of the amount of the TMTP should be maintained over the transitional period
- 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 [Deleted]

[**Note**: paragraphs 2.1 to 2.18 moved to a new Chapter 4, see below]

2A Components of the Transitional Measure

2A1 The TMTP provides relief from the increase in technical provisions which results from changes introduced by Solvency II (in respect of business written before the introduction of the Solvency II regulatory regime), including the introduction of the risk margin. Where the TMTP makes a material contribution to own funds, the PRA expects firms to analyse the material components and drivers of this benefit in order to facilitate better risk management. The PRA expects that this analysis would be included within firms’ own risk and solvency assessments, including how the components may change over time and under a range of

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.

operating conditions, and that firms will make this analysis available to their supervision teams.

3 Consistency of the Solvency I and Solvency II bases

3.1 Pillar 2 insurance liabilities are the starting point for the calculation of the TMTP. Firms are reminded that as set out in condition 1[1] the total amount of the TMTP applied to the Solvency II technical provisions cannot exceed the maximum TMTP defined as the difference between Solvency II technical provisions and Solvency I Pillar 2 technical provisions (calculated in accordance with INSPRU 7). The PRA is aware that firms may inadvertently breach condition 1 through allowances being made for the changes in deferred tax liabilities. Firms are therefore reminded that condition 3[2] (the financial resource requirement ('FRR') test) comparison should be applied after allowing for the impacts of any change in deferred tax and loss-absorbing capacity of deferred tax, but the application of any limit to the TMTP in order to meet condition 3 should not result in condition 1 ceasing to be met.

3.2 The underlying assumptions of both Solvency I Pillar 2 and Solvency II technical provisions are on a best estimate basis. Both Solvency II and the INSPRU 7 rules and guidance as at 31 December 2015 include provision for the best estimate basis to be based on up to date and credible information, and to reflect current operating experience. Firms are expected to review the best estimate assumptions and methodologies at regular intervals, and when appropriate, make changes that reflect changes in operating experience and the firm's risk profile. The PRA previously communicated that in carrying out the initial TMTP calculation, it was assumed that firms would use assumptions consistent with the actual Pillar 2 insurance liabilities valuations used by a firm.[3] This would have included any updated assumptions included in the last ICA carried out by a firm.

3.3 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 Pillar 1 where the FRR test applies or is at risk of applying) 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 changes in operating conditions or the firm's risk profile, rather than being introduced by Solvency II requirements. The need to maintain consistency is a continuous requirement, and applies both in the initial calculation of TMTP and in any subsequent recalculation.

3.4 It should not be assumed that maintaining consistency between Solvency I and Solvency II requires the equalisation of all assumptions. In particular, the review of a firm's Solvency I Individual Capital Assessment and determination of Individual Capital Guidance (ICG), will have considered the aggregate strength of the valuation basis. Hence it may not be appropriate to equalise individual Solvency I assumptions to the equivalent assumptions made in the Solvency II valuation basis without assessing the impact on the aggregate ICA valuation. Firms should document how changes to the Solvency II best estimate basis have been reflected in the Solvency I basis(es) and make this available to their supervision teams.

1 Condition 1 in table 3, Regulation 54 of the Solvency 2 Regulations 2015 (2015/575).
2 Condition 3 in table 3, Regulation 54 of the Solvency 2 Regulations 2015 (2015/575).
3 Paragraphs 3.2 and 3.4 of PRA Supervisory Statement 17/15 UPDATE; November 2016; www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss1715update.aspx.

3.5 The PRA has previously given guidance[1] that it does not generally expect to revisit or reassess ICG as part of the process of approving a firm's application for TMTP relief, but that firms may request, and the PRA will consider conducting, a proportionate review of ICG if it believes that the assumptions underlying their most recent ICA review and ICG are out of date and that this is having a material impact on the TMTP. The PRA will also consider initiating a proportionate review of a firm's ICG if the PRA believes that the ICA basis has not been maintained consistently with the Solvency II basis and may be resulting in an inappropriate calculation of TMTP.

4 Recalculation of the transitional measure

[**Note**: Paragraphs 2.1-2.18 from SS6/16 published in May 2016 have been moved to a new chapter and renumbered accordingly. New text for consultation is set out below.]

…

4.17A The PRA recognises that a proportionate approach in the calculation of the TMTP may involve the use of estimates, for example those used for firms' solvency monitoring processes. The methodology used to calculate the TMTP, in particular where this relies on simplifying approximations, should be clearly documented. The use of less precise methodologies should not result in the systematic distortion of the amount of TMTP claimed and should not introduce material distortion into the evaluation of the firms' own funds and hence solvency position.

4.18A Firms will also need to differentiate between assets and liabilities applicable to business written before and after the introduction of Solvency II. The PRA expects only the former to be included in the TMTP. The PRA expects firms to take a pragmatic approach in identifying the components of the balance sheet which are within the scope of the TMTP calculation. In some cases it may be necessary to make assumptions as to how to do this, for example whether assets should be hypothecated between cohorts of the business written before and after the introduction of the Solvency II regime.

4.19A The decision taken by the PRA in the event of a request for approval to recalculate TMTP will be a decision about whether condition 4[2] is met, ie whether or not the risk profile of the firm has changed materially. The Audit Committee should form a conclusion independently about whether or not the firm continues to meet the other conditions set out in Regulation 54 of the Solvency 2 Regulations 2015. The calculation to be performed will impact the technical provisions and therefore any simplification other than full recalculation of Solvency I and Solvency II figures at the date of the material risk profile change (for example the use of a different calculation date and rolling forwards) is expected to be assessed by the Audit Committee as to whether it complies with Article 56 of the Solvency II Commission Delegated Regulation 2015/35. Neither a firm nor its Audit Committee should take the PRA's approval of a recalculation as being acceptance of any methodology that has been proposed for that recalculation, other than any aspects explicitly agreed with their supervision teams. This responsibility for the Audit Committee also applies at the 24 month recalculation points.

1 SS17/15 UPDATE paragraphs 3.10, 3.11 (supra footnote 4 on previous page).
2 Condition 4 in Table 3, Regulation 54 of the Solvency 2 Regulations 2015 (2015/575).