



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP22/17

Solvency II: Supervisory approval for the volatility adjustment

November 2017



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Responses are requested by Friday 9 February 2018.

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1 Overview

1.1 This consultation paper (CP) sets out the Prudential Regulation Authority's (PRA's) proposals to clarify its expectations in respect of firms seeking approval to apply a volatility adjustment (VA) to insurance and reinsurance business. These proposals clarify the risks that may arise from use of the VA and how firms are expected to consider those risks. The PRA proposes to update Supervisory Statement (SS) 23/15 'Solvency II: supervisory approval for the volatility adjustment'.¹

1.2 This CP is relevant to insurance and reinsurance companies using or intending to use the VA.

1.3 The proposed updates to SS23/15 (see Appendix) should be read in conjunction with:

- the Technical Provisions, Investments, Conditions Governing Business, and Insurance – Senior Insurance Management Functions Parts of the PRA Rulebook;
- the Solvency 2 Regulations 2015;²
- the Commission Delegated Regulation (EU) 2015/35; and
- the European Insurance and Occupational Pensions Authority (EIOPA) Level 3 Guidelines.³

1.4 In the course of reviewing firms' VA applications the PRA has identified particular areas of prudential risk that may arise from using the VA, and which have had to be addressed in the review process. This CP aims to alert all firms considering applications to use the VA to those risks, and to help them to produce high-quality applications that successfully address those risks.

Responses and next steps

1.5 This consultation closes on Friday 9 February 2018. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP22_17@bankofengland.co.uk.

¹ June 2015: www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss2315.aspx.

² Regulation 42(6) of the Regulations (2015/575): www.legislation.gov.uk/ukxi/2015/575/contents/made.

³ Guidelines on the implementation of the long-term guarantee measures: www.eiopa.europa.eu/GuidelinesSII/EIOPA_EN_LTG_GLS.pdf.

2 Proposals

2.1 The PRA proposes the following changes to SS23/15 (see Appendix).

Content of the VA application

2.2 The PRA considers that a firm's governing body should seek advice from a relevant Senior Insurance Manager to strengthen the governance surrounding the application. The PRA proposes to add an additional expectation to the final bullet point in paragraph 2.4 of the SS that a firm's governing body seeks advice from relevant Senior Insurance Managers and the Actuarial function (within their existing responsibilities) as part of endorsing the VA application.

Intended purpose of the VA

2.3 The PRA proposes a new Chapter 2A to set out the VA's intended purpose. The PRA considers that the VA is a tool designed to mitigate rather than increase firms' exposure to artificial balance sheet volatility and to help eliminate the need for insurers to engage in pro-cyclical investment behaviour. Using the VA in a way that is not aligned with its intended purpose could give rise to undue capital relief. The PRA is therefore proposing that firms should consider, before submitting an application, whether the application is consistent with the intended purpose of the VA.

Under-valuation of financial guarantees

2.4 Using the VA to value financial guarantees may pose particular challenges for firms. The PRA proposes that firms consider the appropriateness of the valuation bases used for risk management purposes, independently of whether the VA is used. The PRA proposes to introduce new paragraphs 3.8A1 and 3.8A2 to clarify the PRA's expectations for firms valuing and managing risks associated with financial guarantees.

Solvency Capital Requirement and the Own Risk and Solvency Assessment

2.5 The VA may affect the quantum of the Solvency Capital Requirement (SCR) and the effect can be particularly large for longer-term business. The PRA proposes to introduce new paragraphs 3.8A3 to 3.8A5 to clarify that the PRA expects a firm's SCR to be updated to reflect the use of the VA, and a firm's Own Risk and Solvency Assessment (ORSA) to be updated to capture any risks from the VA that are not covered in the SCR, so that the ORSA continues to fully reflect firms' risk profiles.

Earning the VA in practice

2.6 Firms who use the VA implicitly assume that it is possible to earn this amount in excess of the risk-free rate from assets that are held to cover the corresponding liabilities. The VA is applied for the duration of an insurer's liabilities. The PRA proposes to make an addition to paragraph 3.9 to clarify the PRA's expectations of firms when demonstrating whether the VA can be earned in practice. The PRA proposal expects that where a firm is reliant on the yield from assets with an uncertain return or on the returns achieved on reinvestment to support the use of VA, the firm should consider the risk that the assumed return is not achievable in practice and demonstrate how this risk will be monitored and managed.

Improving clarity

2.7 The PRA also proposes minor drafting changes to paragraphs 1.2, 3.5 and 3.6 to improve the clarity of these paragraphs without changing the underlying policy intent.

3 The PRA's statutory obligations

3.1 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to consult when setting its general policies and practices.¹ In doing so, it is required to comply with several statutory and public law obligations. The PRA meets these obligations by providing the following in its consultations:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective,² insurance objective³ (if applicable), and secondary competition objective;⁴
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with its duty to have regard to the regulatory principles;⁵ and
- a statement as to whether the impact of the proposed policy will be significantly different to mutual than to other persons.

3.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.⁶

3.3 The PRA is also required by the Equality Act 2010⁷ to have regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.4 The proposed changes to SS23/15 clarify the standard expected of firms by the PRA, commensurate to the materiality of the VA benefit to firms. The proposed changes do not impose additional requirements or rules. The overall economic effects of the volatility adjustment have been considered previously, in CP16/14 'Transposition of Solvency II – Part 3'.⁸

Compatibility with the PRA's objectives

3.5 The proposals would contribute to the PRA's general objective to promote the safety and soundness of firms and the PRA's specific insurance objective to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders, by helping the PRA to ensure that the benefit arising from the VA is applied appropriately, thereby avoiding undue capital relief. Further, the proposals in this CP seek to strengthen the firm's governance around VA applications.

3.6 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

1 Section 2L of FSMA.

2 Section 2B of FSMA.

3 Section 2C of FSMA.

4 Section 2H(1) of FSMA.

5 Section 2H(2) and 3B of FSMA.

6 Section 30B of the Bank of England Act 1998.

7 Section 149.

8 August 2014: www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp1614.aspx.

effective competition in the markets for services provided by PRA-authorized persons in carrying out regulated activities. The PRA does not consider that the proposals will have a material effect on competition.

Regulatory principles

3.7 In developing the proposals in this CP, the PRA has had regard to the regulatory principles as set out in FSMA. The PRA considers the proposed updates to be compatible with the regulatory principles and relevant provisions of the Legislative and Regulatory Reform Act 2006.

3.8 The PRA considers that the regulatory principles of most relevance to the proposals are:

- the need to be proportionate – to ensure that the breadth and depth of analysis performed by the firm and the PRA is proportionate to the materiality of the impact of the VA to the firm;
- the need to use resources in the most efficient way – the proposals clarify the PRA’s expectations and the factors that might lead to the PRA exercising an enhanced level of scrutiny, thereby allowing resource to be focussed in a more efficient manner; and
- that the PRA exercise its functions as transparently as possible – the proposal sets out for firms how the PRA expects to exercise its supervisory duties to ensure that a firm’s application evidences compliance with the statutory approval conditions.

Impact on mutuals

3.9 The PRA does not consider that the proposed SS update will have an impact on mutuals that significantly differs from other firms.

HM Treasury recommendation letter

3.10 HM Treasury has made recommendations to the PRC about aspects of the Government’s economic policy to which the PRC should have regard when considering how to advance the objectives of the PRA and apply the regulatory principles set out in FSMA.¹

3.11 The consideration of ‘Better outcome for consumers’ is the one of greatest relevance to the proposed SS update, which is designed to ensure that insurers are adequately capitalised where a VA is applied.

Equality and diversity

3.12 The PRA may not act in an unlawfully discriminatory manner. It is required, under the Equality 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 SS update gives rise to any equality and diversity issues.

¹ Information about the PRC and the recommendations from HM Treasury are available on the Bank’s website at www.bankofengland.co.uk/about/Pages/people/prapeople.aspx.

Appendix Proposed amendments to Supervisory Statement 23/15 'Solvency II: supervisory approval for the volatility adjustment'

Underlining indicates new text and striking through indicates deleted text.

1 Introduction

...

1.2 In particular, this statement clarifies:

- the items that should be included in an application to use the VA;
- how the PRA will use the content of applications to assess whether the statutory conditions for approval to use the VA have been satisfied;
- the VA's intended purpose; and
- how the VA approval process will work; and its interaction with other Solvency II approval processes.

...

2 Content of the application

...

2.4 Applications should include the following information, required under the Solvency II Directive ('the Directive'):

- the written policy on risk management required by Conditions Governing Business 2.4 of the PRA Rulebook, including:
 - the firm's policy on the criteria for the application of the VA, in accordance with Conditions Governing Business 2.5(2) of the PRA Rulebook;
 - the firm's assessment of: the sensitivity of the technical provisions and eligible own funds to the assumptions underlying the calculation of the VA; the possible effect of a forced sale of assets on the eligible own funds; and the impact of a reduction of the VA to zero in accordance with Conditions Governing Business 3.2(3) of the PRA Rulebook;
- as required by Conditions Governing Business 3.1(3), the liquidity plan projecting the incoming and outgoing cash flows in relation to the assets and liabilities subject to the VA;
- where the reduction of the VA to zero would result in non-compliance with the Solvency Capital Requirement (SCR), an analysis of the measures the firm could apply in such a situation to re-establish the level of eligible own funds covering the SCR or to

reduce its risk profile to restore compliance with the SCR, in accordance with Conditions Governing Business 3.3;

- as required by Conditions Governing Business 3.8(4), the assessment of compliance with the capital requirements referred to in Conditions Governing Business 3.8(2)(b), with and without taking into account the VA;
- any information not listed above that the firm believes is relevant; and
- a cover letter stating that the application is endorsed by the ~~board~~ governing body of the firm and that, in the view of the ~~board~~ governing body, the conditions set out in Regulation 43(4) of the Statutory Instrument are met. In forming this view, the governing body should have first taken advice from the relevant Senior Insurance Managers (likely to be principally the Chief Risk Officer, Chief Actuary and possibly a Senior Investment Manager and the Compliance Officer) and from the Actuarial Function.

2A Intended purpose of the VA

2A1. The PRA expects firms to consider, before applying for approval to use the VA, whether the application is consistent with the intended purpose of the VA.

2A2. The purpose of the VA is not to help smooth volatility in the Solvency II balance sheet arising from movements in the risk-free rate. The purpose of the VA is to prevent the requirement for market-consistent valuation of assets and liabilities under Solvency II from dis-incentivising insurers from investing in assets that it would otherwise be appropriate for the insurer to hold, taking into account the nature and duration of their insurance liabilities. The VA aims to mitigate ‘artificial’ balance sheet volatility caused by short-term market volatility in the value of assets by allowing insurers to reflect movements to those asset prices within the market-consistent valuation of the corresponding liabilities. This helps eliminate the need for the insurer to engage in pro-cyclical investment behaviour in order to address this ‘artificial’ balance sheet volatility¹.

2A3. Using the VA in a way that is not aligned with its intended purpose could give rise to undue capital relief. Such use is also likely to be incompatible with good risk management, since it can introduce new risks to the balance sheet, such as the risk of future loss of own funds if the VA reduces in size. And it may suggest that the firm’s risk profile deviates from the assumptions underlying the VA.

2A4. For these reasons, firms are expected to satisfy themselves, and on request the PRA, that the VA is applied in a manner that is consistent with its intended purpose.

¹ See for example Recital 32 of the Omnibus II Directive.

3 Assessing satisfaction of the three statutory conditions

...

Condition 2: the firm does not breach a relevant requirement as a result or consequence of applying the VA

3.5. At no time should a firm's use of the VA result in the firm breaching other requirements of the Directive. Some of tThe prudential risks created by inappropriate use of the VA were highlighted by HM Treasury in its consultation document relating to the VA¹. In light of these risks that the VA may introduce, the PRA expects firms to consider their compliance with the risk management requirements under Conditions Governing Business 2.5 and 3.1–3.7, and the Prudent Person Principle (PPP) under Investments 2–5 of the PRA Rulebook, in particular.

3.6. ~~The risk management requirements referred to in paragraph 3.5 are particularly relevant because~~ Consistent with its intended purpose, the VA enables a firm to smooth the balance sheet impact of short-term volatility in financial markets. This smoothing relies on the underlying assumption that the volatility (and any resulting depression of asset prices) is temporary and that the firm can continue to meet claims as they fall due without resorting to selling assets at temporarily depressed prices.

3.7. Firms should show that this underlying assumption is appropriate given their risk profile. As part of this, firms should demonstrate that they have fully identified any liquidity risk (or other risks) that ~~are~~ may be introduced ~~or affected~~ through the use of the VA, and that they have the adequate understanding, risk mitigation techniques and financial resources to manage those risks.

...

3.8A1. Products containing financial guarantees may pose particular risks where a VA is applied, such as the risk that the cost of providing the guarantee is inadequately provisioned for.

3.8A2. The PRA expects firms to be able to demonstrate, as part of their risk management framework, how they will identify, measure, manage, monitor and report all of the risks that are introduced by use of the VA. Where firms consider risk management actions regarding guarantees (eg hedging decisions), the PRA expects firms to use valuation bases which are appropriate for their business and risk profile, independently of whether the VA is used.

3.8A3. Firms should also ensure that the SCR calculation is appropriately updated to reflect the firm's use of the VA.

¹ www.gov.uk/government/consultations/solvency-ii-resolving-the-remaining-policy-issues-for-uk-transposition/solvency-ii-resolving-the-remaining-policy-issues-for-uk-transposition.

3.8A4. The Own Risk and Solvency Assessment (ORSA) must include an assessment of the significance with which the risk profile of the firm deviates from the assumptions underlying the SCR.¹ This assessment should be updated once the VA has been incorporated into the SCR calculation.

3.8A5. The ORSA must also include the firm's overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the firm,² which should include risks that are not adequately captured within the SCR. For example, Solvency Capital Requirement – General Provisions 3.6 prevents insurers from reflecting the risk of loss of basic own funds resulting from changes to the VA in the SCR but where firms are materially exposed to this risk it should be included within the ORSA. Firms should therefore consider the extent of their exposure to this risk in their ORSA, and any material basis risk that results from divergences between the assets they hold and those underlying the EIOPA reference portfolio.³

3.9. The Prudent Person Principle (PPP) requires that assets held to cover technical provisions are invested in a manner appropriate to the nature and duration of the liabilities. Firms should demonstrate that they have considered the compatibility of their investment strategy with the PPP, given that the VA is used. This consideration should encompass how closely the asset and liability cash flows are matched, and whether the firm is able to meet its obligations as they fall due, including under stressed conditions. It should also take into account the yield on the assets the firm currently holds (or intends to hold in future, following the investment of future premium income or asset maturity proceeds) to cover the insurance liabilities, relative to the yield implicitly assumed in the liability discount rate. This comparison of yields should be performed on an ongoing basis, and not only at the point that an application is submitted. Firms reliant on the yield from assets with an uncertain return, or on the yield from assets they intend to purchase at a future date, should consider the risk that the assumed return is not achievable in practice and demonstrate how this risk will be monitored and managed.

...

1 Rule 3.8(2)(c) of the Conditions Governing Business Part of the PRA Rulebook.

2 Rule 3.8(2)(a) of the Conditions Governing Business Part of the PRA Rulebook.

3 Article 49 of the Commission Delegated Regulations (EU) 2015/35.