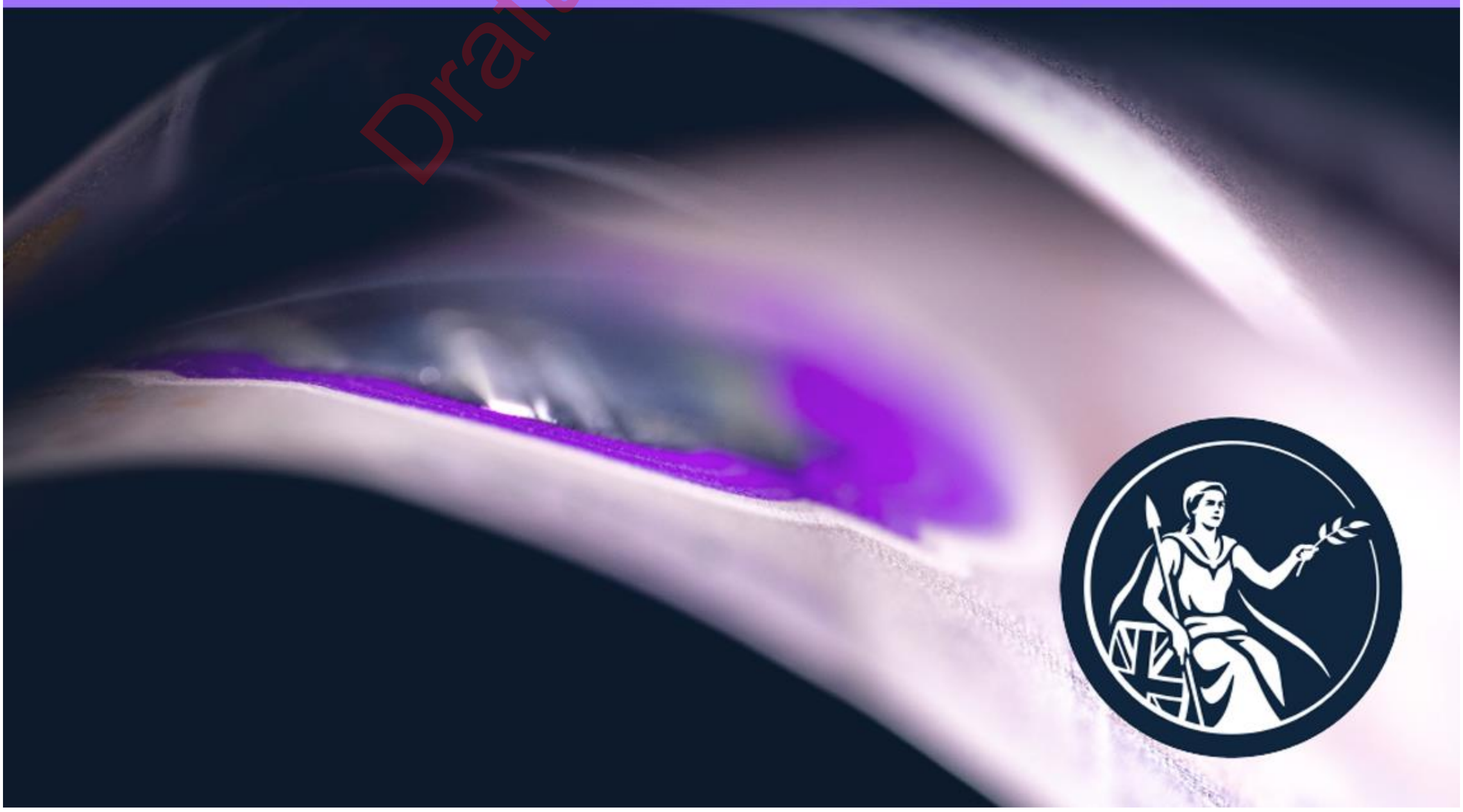
Bank of England PRA

Appendix 3: Draft amendments to SS17/15 – Solvency II: transitional measures on risk-free interest rates and technical provisions

Consultation paper | CP12/23

June 2023



Draft amendments to SS17/15 – Solvency II: transitional measures on risk-free interest rates and technical provisions

In this appendix, new text is underlined and deleted text is struck through.

…

1.1 This supervisory statement[1] is of interest to all UK Solvency II firms ~~that fall within the scope of the Solvency II Directive ('the Directive'),~~[2] and to the Society of Lloyd's, its members and managing agents. In particular, it is relevant to firms that are considering applying for, or that have been granted ~~approval~~ permission to use, either the transitional measure on the risk-free interest rate or the transitional measure on technical provisions ('TMTP)'.

1.2 It sets out the expectations ~~calculation and application process~~ for the use of ~~to be used for~~ these transitional measures, as specified in Transitional Measures 10 and ~~11~~ the Transitional Measures on Technical Provisions Part ~~in~~ of the Prudential Regulation Authority (PRA) Rulebook.

1.3 This statement should be read in conjunction with those chapters of the Transitional Measures and Transitional Measures on Technical Provisions Part, the rules in the rest of the Solvency II Sector of the PRA Rulebook, the Solvency 2 Regulations (2015/575),[3] the statement of policy (SoP) 'Permissions for transitional measures on technical provisions and risk-free interest rates',[3a] ~~the European Insurance and Occupational Pensions Authority (EIOPA) Level 3 Guidelines~~ and the PRA's insurance approach document.[4]

…

3.1 Under Solvency II, firms may apply to the PRA for permission ~~approval~~ to apply ~~a transitional measure for technical provisions (~~TMTP~~)~~. This chapter sets out the PRA's

1 On 21 November 2016, and [date] this SS was updated – see appendix for full details.

2 ~~Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast).~~

3 http://www.legislation.gov.uk/uksi/2015/575/contents/made.

3a https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2023/june/cp1223app4.pdf.

4 Available at https://www.bankofengland.co.uk/prudential-regulation/publication/pras-approach-to-supervision-of-the-banking-and-insurance-sectors.

expectations of insurance business transfers and 100% reinsurance transactions[1] involving TMTP ~~the calculation methodology that firms should use for transitional measure~~.

3.2 Deleted. ~~The scope of this chapter is limited to the calculations a firm must perform to apply the transitional deduction~~.

Calculation of the transitional measure before application of the limit

This section has been deleted.

~~3.3 Solvency I Pillar 2 insurance liabilities are the starting point for the TMTP calculation transitional deduction. They will capture all relevant features of the liabilities, including those that may not be adequately reflected in a firm's Solvency I Pillar 1 technical provisions as set out in INSPRU 1.~~

~~3.4 When calculating the Solvency I 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 Solvency I 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 Solvency I 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 Solvency I 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.~~

~~Part VII~~ Insurance Business Transfers and Reinsured Business

3.7 Deleted. ~~Approval for use of the TMTP remains with the legal entity which sought the approval. For business transferred under Part VII of Financial Services and Markets Act (2000) (FSMA) any associated TMTP relief which applied within the ceding firm will not~~

1 A 100% reinsurance contract is one which transfers to the reinsurer a 100% share of the ceding firm's risk under the reinsured contracts of insurance.

~~therefore be automatically transferred with the liabilities. Both the transferor and transferee should consider how their risk profile has changed.~~

3.7A Firms that use the methodology set out in Transitional Measures on Technical Provisions 5 ('the TMTP method') are required by Transitional Measures on Technical Provisions 6 to make an update to their TMTP methodology following a 'transfer event' which has resulted in a change in the firm's technical provisions to which the TMTP relates. Transfer events are: 1) transfer of business either under Part VII of Financial Services and Markets Act 2000 (FSMA) or the Friendly Societies Act 1992; 2) a 100% reinsurance contract; 3) an amendment to an existing 100% reinsurance contract if there has been a change to the volume of risk to which the reinsurer is exposed; and 4) cancellation or expiration of an 100% reinsurance contract. Such an update would only be permitted if the business that has been transferred or ceded was subject to TMTP prior to the transfer. The PRA expects this update to be based on figures at the effective date of the transfer or transaction.[2]

3.7B The PRA expects that the update described above should result in 'Z_A', continuing to represent the risk margin portion of the total TMTP post- transfer as a percentage of the risk margin on the underlying business post- transfer, as the PRA considers this an assumption underlying TMTP. For the purpose of determining how this ratio has changed due to a transfer event, the PRA expects a firm to use amounts equivalent to the risk margin portion of 'transferred TMTP' as calculated by the transferor or cedant (as relevant) and the risk margin on the technical provisions to which the TMTP permission relates as at the effective date.

3.7C The PRA expects that the update required by Transitional Measures on Technical Provisions 6should result in 'Z_B', continuing to represent the annuity best estimate liabilities (BEL) portion of the total TMTP post transfer as a percentage of the annuity BEL on the underlying business post transfer, as the PRA considers this an assumption underlying TMTP. For the purpose of determining how this ratio has changed due to a transfer event, the PRA expects a firm to use amounts equivalent to the annuity BEL portion of 'transferred TMTP' as calculated by the transferor or cedant (as relevant) and the annuity BEL on the technical provisions to which the TMTP permission relates as at the effective date.

3.7D The PRA expects that the update required by Transitional Measures on Technical Provisions 6 should result in 'C_R', continuing to represent the portion of the non-annuity BEL and technical provisions calculated in accordance with the Technical Provisions 2.5(2) attributable to the total TMTP post transfer, as the PRA considers this an assumption underlying TMTP. As part of the update, the PRA also expects firms to update the

[2] For the avoidance of doubt, the PRA expects that the figures would be after any adjustment for the additional amortisation factor 'W_r' is made.

amortisation factor to account for the amount by which ‘C_R’ has already amortised up until this point.

3.8 Deleted. ~~Where the business transferred is material and should the transferee firm seek to benefit from the TMTP relief in respect of the transferred business, the PRA’s view is that an application to recalculate the value of the TMTP, would be reasonable. where the business transferred was written on or before 31 December 2015.~~

3.8A Where a firm that has permission to use their TMTP methodology as at [DATE OF FINAL POLICY STATEMENT] (the ‘legacy approach’) is transferring business to a TMTP method firm, the PRA expects the transferee to update ‘Z_A’, ‘Z_B’ and ‘C_R’ based on the transferor’s TMTP at the effective date of the transfer or transaction. This should be split, by the transferor, into the risk margin portion of transferred TMTP, the annuity BEL portion of transferred TMTP and the amount of the transferred TMTP attributable to the best estimate non-annuity portion and, if any, the firm’s technical provisions to which the TMTP permission relates calculated in accordance with Technical Provisions 2.5(2).

3.9 Deleted. ~~Furthermore the PRA’s expectation is that the transferor will also need to seek approval to recalculate the value of the TMTP. The value of the TMTP within the transferor would be expected to decrease, reflecting the reduction in business in force.~~

…

Reinsured business

This section has been deleted.

~~3.11 The reinsurance of risks arising from liabilities can result in a similar economic impact to the transfer of business to a third party. A reinsurance arrangement and transfer of business are, however, not equivalent transactions. The reinsurance arrangement is a new contract written by the reinsuring entity which transfers risks, with the original contract remaining in force between the cedant and their policyholder(s).~~

~~3.12 Where reinsurance materially changes the value of technical provisions used to calculate TMTP in the cedant, the PRA expects that the cedant will seek approval to update the calculation of the TMTP.~~

~~3.13 The PRA expects that there may be circumstances under which it would be reasonable for the reinsurer to seek approval to update its calculation of the TMTP given the expected increase in technical provisions which would result from the transaction. However, given the wide variation in the nature of reinsurance arrangements, firms should discuss the position~~

~~with their PRA supervisory contact, and the PRA will need to make a decision on a case-by-case basis considering the specific details of the proposed transaction.~~

…

3.15 Deleted. ~~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, ie the HRGs are those that are used to segment the technical provisions under Solvency II.~~

3.16 For legacy approach firms, ~~T~~ the PRA expects that the only limitations on the level of granularity chosen for the scope of the deduction are that:

(i) an Homogeneous Risk Group (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 Solvency I Pillar 2 insurance liabilities calculation, and to calculate Solvency I Pillar 2 insurance liabilities in respect of these HRGs reliably; 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 measure

This section has been deleted.

~~3.17 The PRA's view is that an 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

This section has been deleted.

~~3.18 The PRA is aware that at 31 December 2015, some firms had not 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 believe 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 firm's ICA that have altered since ICG was last set.~~

~~3.19 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 TMTP

Limiting the amount of the transitional measure in future years

This section has been deleted.

~~4.1 The PRA's default assumption is that once any limit on the amount of the transitional deduction has been determined, 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.~~

…

Amount of TMTP applied and disclosed by a firm

4.2A For all firms with a TMTP permission there is a requirement that the amount of the transitional deduction to be applied by a firm is to be between zero and a maximum amount.[1] If a decision is taken by such a firm to apply less than the maximum amount, the PRA expects the firm to include both the maximum amount and actual TMTP amount in the notes to market disclosures, and to share this information with its supervision team. The firm should maintain a transparent approach to determining the amount of TMTP benefit it is applying. The PRA expects this approach to be followed consistently by firms within all Solvency II reporting including for Quarterly Reporting Templates (QRTs). This approach should also be reflected within a firm's ORSA and risk management framework.

4.2B The PRA expects that a firm's disclosure of its solvency ratio will include an allowance for TMTP no greater than the maximum amount at the relevant reporting date.

Criteria for legacy approach firms

4.2C As set out in paragraph 5.3 of SoP 'Permissions for transitional measures on technical provisions and risk-free interest rates', legacy approach firms were required to meet certain criteria prior to the PRA varying their permission to apply the approach. The PRA expects that legacy approach firms provide evidence that they continue to meet the criteria set out in paragraph 5.3 of SoP 'Permissions for transitional measures on technical provisions and risk-free interest rates' on an annual basis as part of the ORSA.

1 The maximum amount is the maximum number derived from the TMTP method in Transitional Measures on Technical Provisions 5 or the legacy approach outlined in the relevant firm's permission.

Consistency of Solvency I and Solvency II bases for legacy approach firms

4.2D The underlying assumptions of both Solvency I Pillar 2 and Solvency II technical provisions are on a best estimate basis. Both Solvency II and INSPRU 7[2] include provision for the best estimate basis to be based on up-to-date and credible information, and to reflect market conditions. Legacy approach firms are expected to review the best estimate assumptions at regular intervals, and must make updates that reflect changes in market conditions and/or demographic assumptions.

4.2E 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 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 market conditions and/or demographic assumptions, rather than being introduced by Solvency II requirements themselves. The need to maintain consistency is an ongoing expectation, and applies whenever TMTP is calculated.

5 Management of the run-off of the TMTP in future years

5.1 The TMTP cannot be applied after 1 January 2032 ~~There is a sixteen-year linear run off for the TMTP~~.[1]

…

Run-off of TMTP compared with technical provisions

5.5 ~~Firms are expected to allocate the aggregate the TMTP by class of business and~~ Firms' underlying ~~lines of~~ business may run off faster or slower than the ~~16 years~~ transitional period for the TMTP. Where the liabilities run off more quickly this could lead to firms carrying a significant TMTP for business which is no longer in force or has substantially reduced volumes. Alternatively, the TMTP could run off more quickly than the associated liabilities. In this instance, there may be a strain on the emergence of surplus and consequent expected deterioration in the solvency position of the firm.

5.6 The PRA therefore expects firms as part of their risk management to consider carefully:

2 As defined in Transitional Measures on Technical Provisions 1.2

1 ~~Regulation 54 of The Solvency 2 Regulations 2015 (2015/575); www.legislation.gov.uk/uksi/2015/575/contents/made~~. Transitional Measures on Technical Provisions 2.3.

- the projected risk profile ~~relative to that implicit in the initial application for the TMTP~~; and

- the adequacy of technical provisions net of any TMTP.

5.7 The PRA expects that the amount of the TMTP relative to the technical provisions for business remaining in force will be monitored on a continuing basis in firms' own risk and solvency assessments (ORSA). <u>The PRA also expects that firms consider whether there are any risks to meeting their solvency risk appetite over the medium term due to TMTP run-off. The PRA expects firms to share this analysis with their supervisors annually.</u>

6 The approval process

<u>This chapter has been deleted.</u>

~~6.1 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. For planning purposes, the PRA asks firms to notify their usual supervisory contacts at the earliest opportunity if they intend to make an application.~~

~~6.2 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.~~

~~6.3 If further information is required from the firm during the review, the PRA will request this information in writing.~~

~~6.4 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.~~

~~6.5 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.~~

7 Verification of calculations

7.1 The PRA expects that the calculation of the TMTP and the resulting quantum of the deduction, and similarly, any calculation using the transitional measure for the risk-free interest rates and the resulting quantum of the deduction that the use of these risk-free interest rate implies, will be overseen by the Chief Actuary ~~audit committee~~ of the firm, as part of their overall responsibility for the actuarial function. The PRA expects that the responsibilities of the actuarial function in the Conditions Governing Business 6.1(b) and (e) should therefore include assurance around the calculation of TMTP where applicable. ~~The chair of the audit committee will be asked to provide written confirmation to the PRA that the numbers are suitable for use and meet the requirements of the written notice~~. ~~This should be done for the opening Solvency II balance sheet, repeated after any recalculations are performed~~, ~~and on an annual basis.~~ As part of annual year-end reporting ~~For the annual review, where no recalculation has been performed in between periods,~~ the ~~audit committee~~ Chief Actuary is ~~only required~~ expected to confirm that ~~there has been no change in risk profile that would have required a recalculation, and that~~ the TMTP has been calculated in line with the methodology for calculating TMTP that the firm has permission to use and has been appropriately reduced in line with the applicable ~~Solvency II~~ requirements.[1]

8 Interaction with other Solvency II approvals and contingency planning

This chapter has been deleted.

~~8.1 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.~~

~~8.2 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.~~

1 For TMTP method firms this is Transitional Measures on Technical Provisions 5. For legacy approach firms it is detailed in their permission.