Bank of England PRA

Appendix 4: Permissions for transitional measures on technical provisions and risk-free interest rates

Consultation paper | CP12/23

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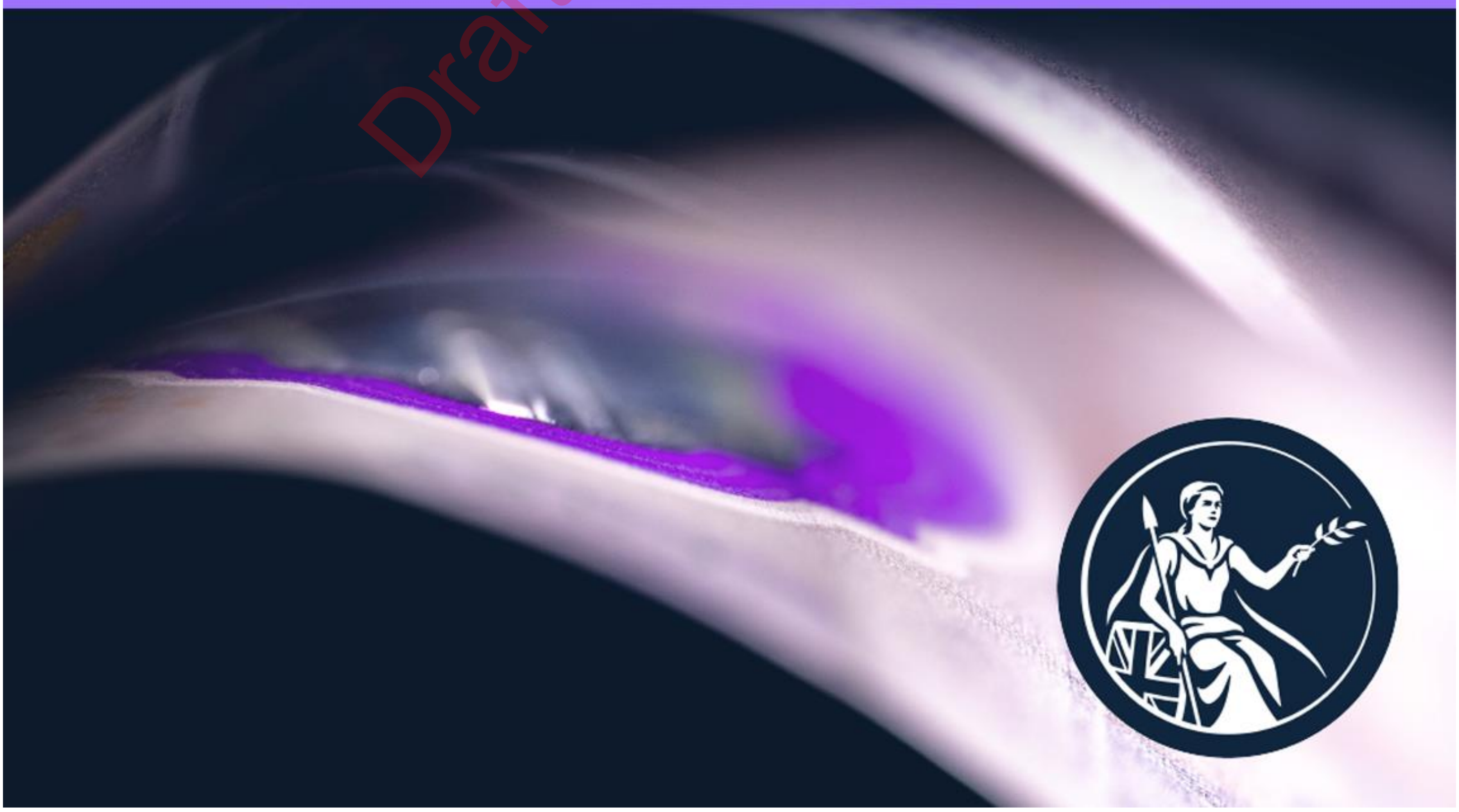

Contents

1. Introduction

1.1 This statement of policy (SoP) sets out the PRA's approach to granting regulatory permissions in relation to the transitional measure on technical provisions (TMTP) and the transitional measure on the risk-free interest rate (TMIR).

1.2 The statement is relevant to all UK Solvency II firms, and the Society of Lloyd's, and its members and managing agents, referred to collectively as 'firms'. It is particularly relevant to firms with permission to apply the TMTP and TMIR, or those that may be acquiring business that benefits from TMTP.

1.3 This SoP should be read in conjunction with those chapters of the Transitional Measures and Transitional Measures on Technical Provisions Part of the PRA Rulebook, the rules in the rest of the Solvency II Sector of the PRA Rulebook, Regulation 53 of the Solvency 2 Regulations 2015,[1] the supervisory statement (SS) – 17/15 Solvency II: Transitional measures on risk-free interest rates and technical provisions, and the PRA's insurance approach document.[2]

1.4 Firms with permission to apply the TMTP must calculate the transitional measure using the methodology specified in the Transitional Measures on Technical Provisions Part of the PRA Rulebook ('the TMTP method'). Furthermore, where the PRA has varied a firm's permission to modify the calculation methodology rules so that it can calculate the TMTP using the methodology applied at [DATE OF PS] (the legacy approach), that firm is subject to the additional requirements set out in the written notice to the firm, which are set out in this SoP.

1.5 This SoP sets out the PRA's approach to considering when it would:

- grant new permissions for firms to apply the TMTP; and
- modify certain TMTP rules, including by way of a variation of a firm's TMTP permission.

1.6 Under relevant FSMA powers, the PRA may on the application of or with the consent of a firm give permission to enable a firm to modify the PRA's rules on the calculation of the technical provisions for the purpose of allowing the firm to apply TMTP relief in accordance with the Transitional Measures on Technical Provisions Part of the Rulebook and, in the circumstances set out in this SoP, waive or modify how those rules apply to a firm. FSMA

1 www.legislation.gov.uk/uksi/2015/575/contents/made.
2 Available at https://www.bankofengland.co.uk/prudential-regulation/publication/pras-approach-to-supervision-of-the-banking-and-insurance-sectors.

powers also permit the PRA to vary, including to modify, or reverse a modification of, the relevant rules, or remove an existing permission and this SoP sets out the circumstances in which the PRA would consider such changes.

2. Approach to TMTP and TMIR permissions

New TMTP permissions

2.1 The PRA considers that all firms that require TMTP for transitioning their balance sheet from Solvency I to Solvency II should have now sought permission for TMTP. Therefore, the PRA generally will not consider new applications for TMTP permission.

2.2 The only circumstance in which the PRA will consider granting a firm a new TMTP permission is if that firm is acquiring a book of business (ie through an insurance business transfer or 100% reinsurance transaction) that already benefits from TMTP. In these instances, a new TMTP permission would be restricted to such acquired business only as required by Transitional Measures on Technical Provisions 2.4.[3] A firm with a new TMTP permission (a 'new TMTP firm') will be required to calculate TMTP using the TMTP method from the date at which the business is acquired. The PRA does not expect to exercise its discretion to allow a new TMTP firm to use the legacy approach.

Approach and process for applications for TMTP and TMIR permissions

2.3 The PRA will also consider applications for the TMIR. For applications for new permissions on TMTP and TMIR (collectively known as 'transitional measures') the considerations below apply.

2.4 For planning purposes, the PRA asks firms to notify their usual supervisory contacts at the earliest opportunity if they intend to make an application. When submitting an application for these transitional measures, firms should inform the PRA of any other approvals or permissions for which they have applied. The PRA encourages firms to also give details of any other approvals or permissions for which they intend to apply.

2.5 For the permission process on the transitional measures, once the PRA has determined the outcome of the application it will provide the firm with written notice of that determination.

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

3 Transitional Measure on Technical Provision 2.4 requires a firm to only apply TMTP to insurance and reinsurance obligations that was subject to a TMTP permission (either in that firm or another firm) as at 31 December 2024.

Initial calculation for new TMTP firms

2.7 A firm applying for new TMTP following a transfer event should include as part of their application its proposed values for 'Z_A' 'Z_B', and 'C_r' for use in the TMTP method. The PRA may reject an application if it is not satisfied with a firm's proposed values. In order for a new TMTP firm to calculate 'Z_A', 'Z_B' and 'C_r', the transferor should express the 'transferred' TMTP[4] in the manner set out in Transitional Measure on Technical Provisions 4.2(2) (ie segment the 'transferred' TMTP into the risk margin portion, the best estimate annuity portion and the best estimate non-annuity portion).[5] The transferee should then calculate 'Z_A' and 'Z_B' in the manner set out in Transitional Measure on Technical Provisions 4.2(3) and 4.2(4) using the transferor's aforementioned calculations for the value of 'A_0' (the risk margin portion of the transferred TMTP) and 'B_0' (the best estimate annuity portion of the transferred TMTP), and the firm's own values for 'D_0' and 'E_0'.[6] The firm should then use the value for 'C_0' (the best estimate non-annuity portion) as calculated by the transferor, to calculate the value of 'C_r', except that the amortisation factor of 'C_r' should be updated to recognise amortisation to that point. The PRA expects that the initial TMTP calculation should ensure that the initial TMTP calculation is no greater than the amount of TMTP that applied to the acquired business immediately prior to the effective date. A new TMTP firm should provide the PRA with details of the initial calculation as part of the application process.

Revoking TMTP permissions

2.8 The PRA may revoke a firm's TMTP permission if it ceases to comply with the applicable requirements and fails to restore compliance with the relevant requirements in a timely and cooperative manner. The PRA may also revoke a firm's TMTP permission if a report submitted under Transitional Measures on Technical Provisions 7.4 shows that it is unrealistic to expect compliance with the solvency capital requirement (SCR) by 2032.

4 The PRA expects firms to use the value of the TMTP that relates to the technical provisions of the transferred business as at the reporting period immediately prior to the effective date of the transfer event.

5 The best estimate non-annuity portion should include the portion of the transferred TMTP attributable to any technical provisions calculated in accordance with Technical Provisions 2.5(2).

6 The firm should calculate the technical provisions on the transferred business for which the transferor had TMTP permission as at the effective date in order to calculate the values for 'D_0' and 'E_0'.

3. Approach to TMTP rule modifications

3.1 Firms may apply to the PRA for permission to apply TMTP relief, with or without relevant modifications to rules in the Transitional Measure on Technical Provisions Part of the Rulebook, as set out in this SoP. The PRA will additionally consider applications to make subsequent modifications, including by way of a variation of a firm's TMTP permission on an ongoing basis in the areas set out in this SoP. From 1 January 2025 the PRA will not consider further applications to use the legacy approach (described further in section 4).

Amortisation of TMTP during the remaining transitional period

3.2 The amortisation approach in Transitional Measures on Technical Provisions 5.2 may be inappropriate for some TMTP method firms due to the run-off pattern of their business. The PRA will consider applications from such firms to waive or modify the rule and instead be required to adopt their proposed alternative amortisation approach. The PRA will consider this in instances where the application of the rule could result in an adverse impact on a firm's solvency position (measured as the impact on a firm's solvency coverage ratio of five percentage points or more). The PRA expects to only waive or modify this element where the firm proposes an alternative amortisation approach which still achieves a consistent amortisation to zero by 1 January 2032. Furthermore, firms would be expected to document the new amortisation approach in their own risk and solvency assessment (ORSA).

Insurance business transfers and reinsurance transactions

3.3 TMTP method firms must update Z_A, Z_B, and C_R used in the Transitional Measures on Technical Provisions 5 in accordance with Transitional Measures on Technical Provisions 6 to reflect the change in risk profile after specific insurance business transfers and reinsurance contracts. The increase or decrease in TMTP as a result of any transfer event cannot be greater than the TMTP that would have been applied by transferor or cedant.[7] However, the PRA will consider applications to apply a modification to Transitional Measures on Technical Provisions 6.2 if firms can provide justification for the transfer event to result in a greater increase or decrease in the amount of TMTP across the transferee and transferor.

7 Transitional Measures on Technical Provisions 6.2. See further details in SS17/15.

4. Firms with permission to use the legacy approach

4.1 Where a firm's TMTP permission allows it to continue to calculate its TMTP under the legacy approach (a 'legacy approach firm'), it is expected by SS17/15 to demonstrate to the PRA on an annual basis that it continues to meet the criteria relevant to this variation, as detailed in chapter 5 of this SoP.

4.2 A summary of the requirements that the PRA expects to impose on legacy approach firms is included below. The requirements are detailed in the written notice issued by the PRA to the firm, so the wording may differ from below. The PRA expects to require a legacy approach firm to:

- calculate the TMTP at each reporting period, this does not require regulatory approval;
- apply the methodologies for calculating Solvency I Pillar 2 technical provisions that they were using as at [date of PS];
- not make any further changes or simplifications to the aforementioned methodologies;
- only make changes to Solvency I Pillar 2 best estimate assumptions to reflect changes in market conditions and/or demographic assumptions, and not make any other changes to Solvency I Pillar 2 best estimate assumptions;
- notwithstanding the requirements for no assumption or methodology changes, where it has approval for the matching adjustment and invests in an asset with new MA-eligible features which it did not hold prior to 2016, assume that the new asset class carried the same level of Solvency I illiquidity premium benefit as the rest of the relevant asset portfolio.
- limit the technical provisions to which the TMTP permission relates to the technical provisions that the firm had a TMTP permission for at 31 December 2024; and
- apply an amortisation approach that runs off TMTP in a consistent manner to be zero by 1 January 2032, ie so that the amortisation applied each year does not lead to a 'cliff-edge effect' where larger decreases are required in the years immediately prior to 2032.

4.3 The PRA will also not conduct further reviews of a firm's Individual Capital Guidance.

4.4 In the case of transfer events that involve acquiring business that is subject to TMTP, a legacy approach firm may wish to apply TMTP to the acquired business. In this situation, the PRA would permit legacy approach firms to apply for a modification of its requirements in order to extend the scope of its TMTP permission to cover the acquired business, and if necessary to update their Solvency I methodologies to accept the acquired business. The PRA will only consider such applications if the firm can demonstrate that the modifications will result in an increase in TMTP that is no greater than the amount of TMTP that applied to the relevant insurance and reinsurance obligations covered by any transfer event immediately prior to the transfer event. Firms should submit as part of their application, a proposal on how the legacy approach method used by the firm should be modified to ensure that no additional TMTP is created due to differences in how the transferor and the firm calculate their technical provisions. In granting the waiver or modification to allow the firm to apply TMTP to the acquired business, the PRA expects to also modify the legacy approach method the firm is required to use to calculate TMTP to include this proposed change. Firms should make an application within two months of any transfer event.

5. Criteria for legacy approach firms

5.1 When it considered whether to vary TMTP permissions to enable firms to use the legacy approach, the PRA assessed if calculating the TMTP using the TMTP method would lead to a material financial impact under a range of economic scenarios compared with calculating the TMTP using the legacy approach for a firm.

5.2 The PRA also considered evidence that using the TMTP method rather than the legacy approach would:

(i) carry a disproportionately high cost of compliance for the firm; or

(ii) significantly disrupt the firm's management practices.

Assessing the criteria

5.3 With respect to paragraph 5.2, the PRA generally considered that the TMTP calculated under the TMTP method was materially different from the legacy approach if a comparison of the two different approaches under a range of forward-looking economic scenarios could result in a difference in a firm's solvency coverage ratio of five percentage points or more. The PRA considered such a comparison to be reasonable where the assessment, on a forward-looking basis:

(i) included a comparison of the two different approaches over an appropriate time horizon, consistent with the scenarios in the firm's medium term capital management plan;

(ii) included a separate consideration of stress conditions, which are consistent with the reporting of sensitivities set out in SS 7/17 – Solvency II: Data collection of market risk sensitivities; and

(iii) took account of the expected run-off of the business eligible for TMTP, and the resulting impact on the amount of TMTP.

5.4 As noted in 4.2C of SS17/15 – Solvency II: transitional measures on risk-free interest rates and technical provisions, the PRA expects that legacy approach firms provide evidence that they continue to meet the criteria set out in 5.1-5.3 on an annual basis as part of their ORSA.

5.5 If a firm considers that it no longer meets the criteria set out in this SoP it should notify the PRA of this within three months. If a firm no longer wishes to use the legacy approach, it should also notify the PRA of this. In these situations, the PRA will consider varying a firm's TMTP permission so that it must calculate TMTP using the TMTP method for the remainder of the transitional period. The PRA will consider all relevant factors when determining the appropriate point at which a firm should begin using the TMTP method. The PRA would expect this to be no later than 12 months from the date on which the firm initially notified the PRA that the criteria in this section are no longer met or that it no longer wishes to use the legacy approach.