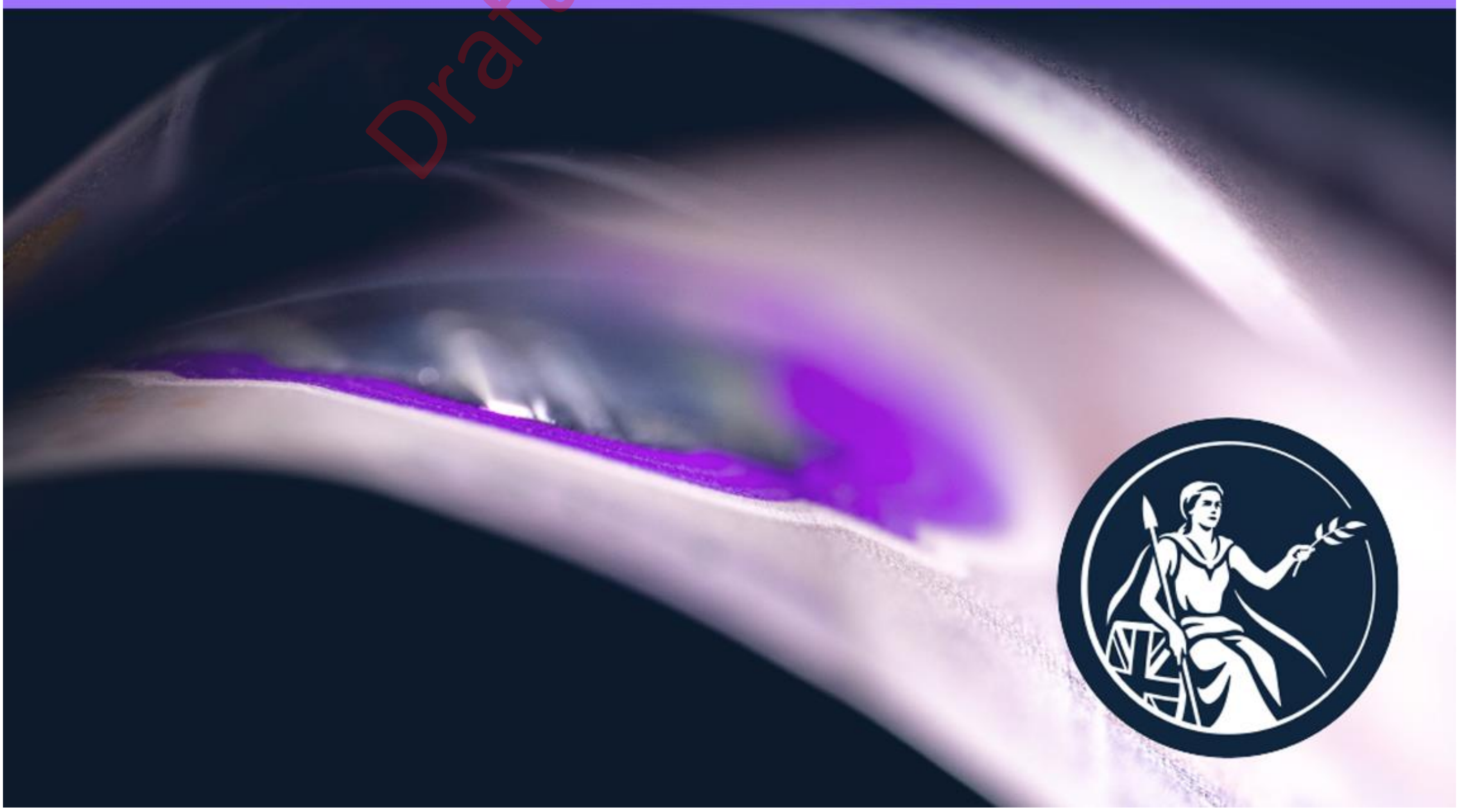
Bank of England PRA

Appendix 4: Draft amendments to statement of policy – Solvency II: The PRA's approach to the publication of Solvency II technical information

Draft statement of policy

April 2024



Draft amendments to statement of policy – Solvency II: The PRA's approach to the publication of Solvency II technical information

Draft statement of policy

April 2024

Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

Contents **2**

1: Background **4**

2: Overview of the PRA's approach **4**

3: ~~Variations by the~~ PRA ~~to EIOPA~~ methodologies and judgements **5**

PRA relevant currencies 5

Basic risk-free rates 5

Extrapolation of the RFR 6

Reference portfolios (RPs) for the Volatility Adjustment 7

Risk Corrected Currency Spread 8

4: Symmetric adjustment of the equity capital charge (SAECC) **9**

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1: Background

1.1 The Prudential Regulation Authority (PRA) is required to publish technical information (TI) ~~necessary for the valuation of insurance liabilities for each relevant currency~~ that it considers appropriate relating to the calculation of technical provisions.[1] This Statement of Policy (SoP) explains how the PRA fulfils its obligations in this regard. It also explains the PRA's approach to calculating the symmetric adjustment to the equity capital charge (SAECC), which is relevant to calculation of the SCR by standard formula firms. UK firms should use the PRA's published TI for regulatory reporting ~~from and including 11:00pm on Thursday 31 December 2020~~.

2: Overview of the PRA's approach

2.1 The PRA has ~~retained the~~ adopted methodologies and judgements ~~that~~ consistent with those the European Insurance and Occupational Pensions Authority (EIOPA) incorporates in its TI as at the end of the transition period (TP), with some exceptions as set out in Chapter 3. Additionally, ~~from the end of the temporary transitional powers (TTP) on~~ since 31st March 2022, the PRA has applie~~s~~d ~~the preferential~~ a ~~(~~30%~~)~~ long term average spread calculation only to UK central government and central bank exposures and no longer to ~~EU~~ EEA exposures.[2]

2.1A In determining the published technical information on the risk-free interest rate term structures for PRA relevant currencies the PRA uses techniques, data specifications, and parameters which are transparent, prudent, reliable, objective, and consistent over time.

2.1B The PRA's approach to the calculation of the basic risk-free interest rate term structures for PRA relevant currencies is based on the following assumptions:

- firms are able to earn the rates in a risk-free manner in practice; and

1 ~~Regulation 4B of the Solvency 2 Regulations 2015/575. The PRA published the first set of TI in January 2021~~ The Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023 (legislation.gov.uk).

2 **Consultation Paper 18/19: UK withdrawal from the EU: Changes following extension of Article 50** - Annex BU (Amendments to the Technical Provisions Part), section 7.3.
The CP proposals were confirmed as final policy via the joint **Bank and PRA statement** in April 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/joint-bank-pra-statement-on-proposed-use-of-ttp-at-the-end-of-the-transition-period

- the rates are reliably determined based on financial instruments traded in deep, liquid, and transparent financial markets.

The PRA calculates the rates of the risk-free interest rate term structure separately for each relevant currency and maturity, based on all information and data relevant for those relevant currencies and maturities.

2.1C The PRA determines and publishes a volatility adjustment for each relevant currency. Those volatility adjustments:

a) are based on the spread between the interest rate that could be earned from the assets that are representative of firms' investments in that currency and the rates of the relevant basic risk-free interest rate term structure for that currency, and

b) correspond to 65% of the risk-corrected currency spread as set out in paragraphs 3.13 to 3.15.

3: ~~Variations by the~~ PRA ~~to EIOPA~~ methodologies and judgements

PRA relevant currencies

3.6 Where a UK insurer has technical provisions in a particular currency for which the PRA does not publish TI, it is the~~a~~ firm's responsibility to propose TI that complies with ~~Solvency II~~ the requirements ~~and standards~~ in the PRA Rulebook. Where there is additional relevant policy material, eg supervisory statements, firms should also comply with this material or explain their approach and justify it to ~~and to justify this approach to its~~ their supervisors. The PRA reminds firms that they ~~it~~ can only apply the VA for currencies ~~and national markets~~ where a VA is ~~has been~~ published by the PRA.

Basic risk-free rates

3.6AA The PRA derives the basic RFR for each relevant currency and maturity from interest rate swap rates in that currency, adjusted to take account of credit risk.

3.6AB The PRA will use government bond rates, adjusted to take account of credit risk, to derive the basic RFR where:

- interest rate swap rates are not available from deep, liquid, and transparent financial markets for the relevant currency and maturity; and
- government bond rates are available from deep, liquid, and transparent markets.

3.6AC The adjustment for credit risk reflects the level of credit risk inherent in the financial instrument used to derive the basic RFR. If the relevant financial instrument contains negligible credit risk, the adjustment may be zero.

3.6A The PRA needs to make judgements about the reference instruments and associated Credit Risk Adjustments (CRAs) to use when constructing the basic RFRs for PRA relevant currencies. For example, some reference instruments and CRAs have been updated in light of the cessation of Libor settings. To satisfy paragraphs 3.6AA-3.6AC the ~~The~~ PRA will make available, for example via the TI area of the Bank of England's website, relevant information about any changes to the reference instruments and CRAs used to construct the basic RFRs for PRA relevant currencies. The PRA aims to give firms at least three months' notice of such changes.

Extrapolation of the RFR

3.6AD The PRA will use the same principles for extrapolating the RFR term structure in all relevant currencies. This also applies to the determination of the longest maturities for which interest rates can be observed in a deep, liquid, and transparent market and the mechanism to ensure a smooth convergence to the ultimate forward rate.

3.6AE The PRA will publish basic extrapolated risk-free interest rate term structures for PRA relevant currencies. Firms with Matching Adjustment (MA) permission can apply the MA to those structures.

3.6AF Where the PRA publishes risk-free interest rate term structures for PRA relevant currencies including a volatility adjustment, the PRA will apply extrapolation after applying the volatility adjustment to the basic RFR.

3.6 AG For each relevant currency the ultimate forward rate takes account of expectations of the long-term real interest rate and expected inflation, provided those expectations can be determined for that currency in a reliable manner. The PRA will maintain stability in the ultimate forward rate for each relevant currency and will only make changes where there are changes in long-term expectations. The PRA uses the same methodology as that specified by EIOPA in its Report on the Calculation of the UFR for 2024.[3]

[3] https://www.eiopa.europa.eu/eiopa-publishes-ultimate-forward-rate-ufr-2024-2023-04-27_en

3.6AH The ultimate forward rate does not include a term premium to reflect the additional risk of holding long-term investments.

Reference portfolios (RPs) for the Volatility Adjustment

3.7A The RP for a relevant currency is one that is representative of the assets which are denominated in that currency and which firms are invested in to cover the best estimate for insurance and reinsurance obligations denominated in that currency.

3.8 The PRA derives VA RPs using a similar ~~the same~~ technical approach as EIOPA.[4] Further details on this, including, ~~except for~~ specific areas where the PRA's approach differs, are ~~as~~ explained below. The methods applied by the PRA when determining the RPs are the same for all currencies.

3.8A For each relevant currency, the assets of a RP are those for which a reliable market value is observable, are valued in accordance with the rules in the Valuation Part of the PRA Rulebook,[5] and are traded in markets that, except in periods of stressed liquidity, are active, deep, liquid, and transparent. The PRA only expects to include financial instruments that do not have a reliable market value and aren't traded in markets that are active, deep, liquid, and transparent where the status is temporary, and that market is expected to comply with those criteria again within a reasonable time period. Furthermore, the RP exhibits the following features:

a) where available, the portfolio is based on relevant indices which are readily available to the public and published criteria exist for when and how the constituents of those indices will be changed;

b) it includes all of the following:

- bonds, securitisations, and loans, including mortgage loans;
- equity; and
- property.

For the purposes of point (a), investments of firms in collective investment undertakings and other investments packaged as funds are treated as investments in the underlying assets.

3.9 The derivation of the VA RPs reflects UK firms' asset exposures. Specifically:

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[4] https://www.eiopa.europa.eu/document/download/9c56797a-ff5c-428a-897d-9dfc9346d9b1_en?filename=16.12.2020%20%E2%80%93%20Technical%20documentation
[5] PRA rulebook Valuation 6.

- the VA RPs used to calculate the GBP VA are derived using data from the Quantitative Reporting Templates (QRTs) submitted to the PRA by UK solo insurers; and

- the VA RPs for non-GBP PRA relevant currencies are derived by taking a weighted average of:

  (i) EIOPA's published VA RPs derived using QRT data submitted to EIOPA; and

  (ii) the VA RPs derived using QRT data submitted to the PRA for (UK) parent undertakings (as defined in the Glossary Part of the PRA Rulebook ~~Solvency 2 Regulations 2015~~). This QRT data is aggregated together with solo QRT data submitted to the PRA by the Society of Lloyd's. The respective RPs are weighted using the aggregate market value of assets as reported in the QRT data of (i) European Economic Area firms and (ii) (UK) parent undertakings ~~(as defined in the Solvency 2 Regulations 2015)~~ and the Society of Lloyd's.

3.11 The PRA does not publish separate ~~published~~ country VA RPs for ~~GBP is the same as the currency VA RP~~ any of the relevant currencies.

Risk Corrected Currency Spread

3.13 The PRA calculates the risk-corrected currency spread referred to in paragraph 2.1C(b)as the difference between the spread referred to in paragraph 2.1C(a) and the portion of that spread that is attributable to a realistic assessment of expected losses or unexpected credit risk or other risk of the assets.

3.14 For each relevant currency the RP spread referred to in paragraph 3.13 is equal to the following:

$$S = w_{gov} \cdot \max(S_{gov}, 0) + w_{corp} \cdot \max(S_{corp}, 0),$$

where:

(a) w_{gov} denotes the ratio of the value of government bonds included in the RP of assets for that currency and the value of all the assets included in that RP;

(b) S_{gov} denotes the average currency spread on government bonds included in the RP of assets for that currency;

(c) w_{corp} denotes the ratio of the value of bonds other than government bonds, loans, and securitisations included in the RP of assets for that currency and the value of all the assets included in that RP;

(d) S_{corp} denotes the average currency spread on bonds other than government bonds, loans, and securitisations included in the RP of assets for that currency.

For the purposes of this calculation 'government bonds' means exposures to central governments and central banks.

3.15 The PRA calculates the portion of the average currency spread that is attributable to a realistic assessment of expected losses, unexpected credit risk or any other risk referred to in paragraph 3.13 in the same manner as the fundamental spread referred to in Regulation 6(1) to (8) of The Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023.

4: Symmetric adjustment of the equity capital charge (SAECC)

4.1 The PRA will calculate and publish an SAECC figure in line with the rules set out in the Solvency Capital Requirement – Standard Formula Part of the Rulebook, Section 3D – Market Risk Module 3D12, 3D13, and 3D14 on a monthly basis. Firms can use that figure to adjust the standard equity capital charge in their calculation of the equity risk sub-module referred to in rule 3.11(2)(b) of the Solvency Capital Requirement – Standard Formula Part of the PRA Rulebook.