

# Bank of England PRA

## Appendix 5: New draft statement of policy – Solvency II: Volatility Adjustment Permissions

**New draft statement of policy**

April 2024

Draft for consultation



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# 1: Introduction

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1.1 This statement of policy (SoP) sets out the Prudential Regulation Authority's (PRA's) approach to granting regulatory permissions in relation to the volatility adjustment (VA), as well as variations to those permissions, and the circumstances in which the PRA may consider revoking a firm's VA permission.

1.2 When granting these permissions, the PRA would exercise its powers under s138BA of the Financial Services and Markets Act 2000 (FSMA), which would have the effect of waiving or modifying the PRA's rules relating to the calculation of technical provisions to allow a firm to apply the VA in accordance with Chapter 8 of the Technical Provisions Part of the PRA Rulebook. Using the same powers under FSMA, the PRA may also vary a firm's permission to apply the VA and/or revoke a firm's VA permission.

1.3 This SoP 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 VA, or those seeking permission to apply the VA.

1.4 This SoP should be read in conjunction with the Technical Provisions Part of the PRA Rulebook, the Investments Part of the PRA Rulebook and supervisory statement (SS) 9/18 – Solvency II: Internal models – modelling of the volatility adjustment,<sup>1</sup> and the PRA's approach to insurance supervision document.<sup>2</sup>

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<sup>1</sup> <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2018/ss918.pdf>.

<sup>2</sup> Available at: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/insurance-approach-2023.pdf>.

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## 2: The procedure for considering VA permissions

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2.1 This chapter outlines the PRA's approach to considering, granting, and varying permission for a firm to apply the VA to the relevant risk-free interest rate term structure for calculating the best estimate of its insurance and/or reinsurance liabilities.

2.2 This chapter covers both initial VA applications by firms that do not already have permission to apply the VA and applications to vary VA permissions, where a firm seeks to change the scope of an existing VA permission. It also covers possible revocation of VA permissions by the PRA.

### Intended purpose of the VA

2.3 The PRA expects firms to consider, before applying for permission to apply the VA, whether the application is consistent with the intended purpose of the VA.

2.4 The purpose of the VA is to mitigate the effect of exaggerations of bond spreads to prevent pro-cyclical behaviour. The PRA considers that the VA achieves this by preventing the requirement for market-consistent valuation of assets and liabilities under the Valuation, Technical Provisions, and Technical Provisions – Further Requirements Parts of the PRA Rulebook from dis-incentivising an insurer from investing in assets that would otherwise be appropriate for the insurer to hold, taking into account the nature and duration of its insurance liabilities.

2.5 The VA therefore aims to mitigate 'artificial' balance sheet volatility caused by short-term market volatility in the value of assets arising from the exaggerations of bond spreads by allowing insurers to reflect movements to those asset prices within the market-consistent valuation of the corresponding liabilities. The purpose of the VA is not to help smooth volatility generally in the Solvency II balance sheet arising from movements in the risk-free rate.

2.6 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 a firm's balance sheet, such as the risk of future loss of own funds if the VA reduces in size. Such impacts may suggest that a firm's risk profile deviates from the assumptions underlying the VA.

2.7 For these reasons, firms are expected to satisfy themselves and, on request, demonstrate to the PRA how they have satisfied themselves that the VA is applied in a manner that is consistent with its intended purpose.

## Criteria for granting VA permissions

2.8 The PRA expects to grant permission to apply the VA where the following criteria are met:

- the VA is applied correctly to the relevant risk-free interest rate term structure in order to calculate the best estimate of insurance and/or reinsurance liabilities;
- the firm does not breach a relevant requirement as a result or consequence of applying the VA;<sup>3</sup> and
- the application of the VA does not create an incentive for the firm to engage in pro-cyclical investment behaviour.

## Content of application for permission to apply the VA

2.9 A firm should submit a written application to the PRA for permission to apply the VA. The application should be made in accordance with any relevant procedural requirements under section 138BA of FSMA and should incorporate all relevant documentary evidence. When compiling an application, a firm should consider the criteria noted in paragraph 2.8 above and ensure that the content included in the application is sufficient and adequate for the PRA to determine whether the firm satisfies those criteria.

2.10 When considering the level of explanation, description or evidence to provide in an application, a firm should have regard to the principle of proportionality. The greater the impact of the VA on a firm's financial position and risk profile, the greater the expected level of detail and justification in the application. The PRA will adopt a proportionate approach when reviewing applications, consistent with its general supervisory approach.

2.11 Applications should include the following information:

- the written policy on risk management required by Conditions Governing Business 2.4, including:

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<sup>3</sup> For clarity, the PRA considers particularly relevant requirements relating to use of the VA are likely to include: rules 2.5 and 3.1 to 3.7 of the Conditions Governing Business Part of the PRA Rulebook, and Chapters 2 to 5 of the Investments Part, relating to the Prudent Person Principle.

- the firm's policy on the criteria for the application of the VA, in accordance with Conditions Governing Business 2.5(2);
- 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);
- 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 considers relevant; and
- a cover letter stating that the application is endorsed by the senior manager responsible for the ORSA that is presented to the firm's governing body and explaining how the criteria in paragraph 2.8 above are met.

2.12 When submitting an application for permission to apply the VA, a firm should inform the PRA of any other permissions for which it has applied. The PRA encourages firms to also provide details of any other permissions for which they intend to apply during the next 12 months.

2.13 Where a firm applies for permission to use any of the transitional measures at the same time as applying for permission to apply the VA, it should provide sensitivity tests showing the impact on the transitional measure(s) if permission for its application to use the VA is granted or rejected.

## Assessment of the application

2.14 The PRA may request additional information necessary for carrying out its assessment. The PRA will specify any additional information required and the reasons for the request.

2.15 The appendix shows, at a high level, how a firm could use its application to demonstrate that each of the three criteria set out in paragraph 2.8 are met. The suggested content is not exhaustive, but instead aims to indicate what the PRA will look for when assessing whether the criteria for VA permission are met.

2.16 The PRA has set out supporting detail as regards its assessment of each of the three criteria in the following paragraphs.

### **Criterion 1: the VA is applied correctly to the relevant risk-free interest rate term structure in order to calculate the best estimate**

2.17 In order to grant a permission to apply the VA, the PRA will consider whether the firm has provided evidence that the correct VA would be applied to the insurance obligations, taking into account the currency of the obligations.

2.18 To evidence this, a firm should clearly describe the liabilities to which the VA is intended to apply and the currencies in which the obligations are denominated. A firm should also confirm that it does not apply a matching adjustment to the obligations. These items should form part of a firm's written policy on criteria for application of the VA.

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

2.19 At no time should a firm's use of the VA result in the firm breaching other requirements in the PRA Rulebook. Some of the prudential risks created by inappropriate use of the VA were highlighted by HM Treasury in its consultation document relating to the VA.<sup>4</sup> In light of the 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 to 3.7, and Chapters 2 to 5 in the Investments Part, in particular.

2.20 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.

2.21 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 may be introduced through the use of the VA, and that they have the

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<sup>4</sup> <https://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>.



adequate understanding, risk mitigation techniques, and financial resources to manage those risks.

2.22 A key factor is the liquidity of the liabilities to which the VA is applied. The claim characteristics and surrender terms of insurance products vary widely. The PRA expects firms to consider the liquidity of their liabilities as part of the policy on the criteria for applying the VA. In general, the liability cash-flows to which VA is applied should be sufficiently predictable that the firm can demonstrably manage any resulting liquidity risk.

2.23 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.

2.24 The PRA expects firms to be able to demonstrate, as part of their risk management frameworks, 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 that are appropriate for their business and risk profiles, independently of whether the VA is used.

2.25 A firm should also ensure that its SCR calculation is appropriately updated to reflect the firm's use of the VA.

2.26 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.<sup>5</sup> This assessment should be updated once the VA has been incorporated into the SCR calculation.

2.27 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,<sup>6</sup> 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.

2.28 Rule 3.1 in the Investments Part requires a firm to ensure that assets held to cover its technical provisions are invested in a manner appropriate to the nature and duration of its insurance and reinsurance liabilities. A firm should demonstrate that it has considered the compatibility of its investment strategy with that rule and other rules within Chapters 2 to 5 in the Investments Part, 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

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<sup>5</sup> Rule 3.8(2)(c) of the Conditions Governing Business Part.

<sup>6</sup> Rule 3.8(2)(a) of the Conditions Governing Business Part.

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 for VA permission 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 they will monitor and manage this risk.

### **Criterion 3: the application of the VA does not create an incentive for the firm to engage in pro-cyclical investment behaviour**

2.29 In order to grant a permission to apply the VA, the PRA will consider whether the firm has provided evidence that use of the VA will not result in pro-cyclical investment behaviour. In this context, pro-cyclical behaviour can be described as a firm increasing the risk profile of asset portfolios (by buying risky assets) during stable or upturn periods, and then de-risking those asset portfolios (by selling those risky assets) during unstable or downturn periods.

2.30 To evidence this, a firm should describe the interaction between its investment policy and the use of the VA. Where a firm holds an asset that it would reasonably expect to sell to meet outgo during a stressed or downturn period, the firm should be able to show that its decision to hold that asset is independent of its decisions to use the VA. Conversely, if use of the VA is a material driver for a firm to invest in a given asset, the firm should demonstrate that it expects to be able to hold that asset throughout any period of market stress.

2.31 The firm's liquidity plan, and the demonstration of the effect of forced sales of assets on the firm's own funds, will also help the PRA to determine whether the firm's proposed use of the VA will support the underlying policy intent of reducing pro-cyclical behaviour.

## **Decision on the application**

2.32 When the PRA has reached a decision on an application for VA permission, it will notify the firm in writing with its decision. Where the PRA grants permission, the written notice will specify the scope of the permission and the starting date from which the firm can apply the VA. Where the PRA does not grant the permission, it will specify the reasons on which the decision is based.

2.33 Assuming that the firm has provided a sufficient amount and quality of evidence to allow the PRA to make a decision, and the need for additional information and/or clarification is limited, the PRA expects to reach a decision on an application for VA permission within a period of 6 months from the date of receipt of a complete application. Having regard to its desire to operate an efficient and effective permission process, the PRA will endeavour to

make decisions within a shorter timeframe where possible. In particular, for applications for VA permissions that are not dependent on supervisory decisions pertaining to other permissions (eg relating to an internal model application), the PRA will endeavour to make a decision within 6 weeks from receipt of a complete application.

## **The PRA's powers to revoke permission to apply the VA**

2.34 The PRA's power to grant a firm permission to apply the VA under section 138BA of FSMA also permits the PRA to revoke a VA permission.

2.35 The PRA may consider it appropriate to revoke a firm's VA permission where the firm's use of the VA does not satisfy one more of the criteria set out in paragraph 2.8. The PRA would exercise its power to revoke VA permissions in a proportionate manner.

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### 3: Appendix

Indicative mapping of application content to the criteria in paragraph 2.8.

Conditions Governing Business Part	Item in Application	Condition for Approval of VA		
		VA is correctly applied	Use of VA is consistent with other requirements	VA does not create incentives for pro-cyclical behaviour
2.5	Policy on the criteria for application of the VA	Description of obligations to which the VA will be applied including currency and country of sale.  Confirmation that the MA is not applied to the same liabilities.	Description on how assets held by the firm are invested consistently with the Prudent Person Principle given that the firm applies the VA.  Evidence that liability features, eg surrender terms, are taken into account when deciding whether to apply the VA.	Description of the link between the investment policy and use of the VA.
3.2(3)	Sensitivity of technical provisions and eligible own funds to underlying assumptions	Sensitivity analysis demonstrating that the firm understands the key drivers that would cause the VA to move and the resultant effect on technical provisions and own funds.		
3.2(3)	Possible effects of forced sales on own funds			Demonstration that the possible forced sale of assets under stressed conditions would not have a material effect on the level of own funds.
3.2(3)	Impact of a reduction in the VA to zero	Quantitative illustration of effect of the VA on the firm's financial position, including technical provisions, own funds and capital requirements.		Qualitative description of further impacts/actions the firm would take if the VA reduced to zero.
3.1(3)	Liquidity plan projecting the incoming and outgoing cash flows relating to assets and liabilities subject to the VA		Demonstration that the firm has adequate understanding, risk mitigation and financial resources to manage the liquidity risk on the business to which the VA is applied.	Demonstration that the firm has sufficient liquidity to meet claims on an ongoing basis during stressed periods without resorting to selling illiquid assets.
3.3	Remedial actions if reduction of the VA to zero results in a SCR breach			Demonstration that loss of the VA would not lead to pro-cyclical de-risking activity.
3.8(4)	Own Risk and Solvency Assessment (ORSA) extract: Assessment of compliance with capital requirements with and without VA		Demonstration that the VA is adequately reflected in the ORSA.	