25 November 2016: This letter has been archived. Appendix 8 of Policy Statement 33/16 lists the supervisory statements in which the PRA's expectations, where relevant, are available.

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Volatility adjustment in the modelling of market and credit risk stresses

The PRA is aware that a number of firms are seeking to include methodology in their internal models which would anticipate future changes in the volatility adjustment (VA) in the modelling of market and credit risk stresses. The PRA's view is that firms should not assume any change to the level of VA (expressed as the number of basis points in addition to the basic risk free curve) when calculating the solvency capital requirement (SCR). This view is consistent with the purpose of the VA, which is to provide countercyclical relief to firms' balance sheets. Anticipating this relief via a reduction in capital requirements would frustrate this purpose. Such an approach is consistent with the rule contained in the Solvency II Firms: Solvency Capital Requirement – General Provisions 3.6 Part of the Rulebook (which transposes Article 77d(6) of the Solvency II Directive).

The PRA is also of the view that, in practice, it would be very difficult for firms reliably to model changes to the requisite standard; the modelling of changes in the VA would need to make allowance for a number of complex factors, including changes in the relative asset weightings in the reference portfolio made by the relevant authorities (for country and currency markets), ensuring the ongoing adequacy of implied technical provisions bases, interaction with exposure to lapse and mass lapse risks, and interaction with policyholder behaviour. Firms using the standard formula to calculate their SCR are not allowed to assume any change in the level of the VA.

If EIOPA should decide to issue guidance on how to treat the VA in calculating the SCR using an internal model in future, the PRA would consider that carefully and would provide an update to the UK industry on its views, as necessary.

June 2015