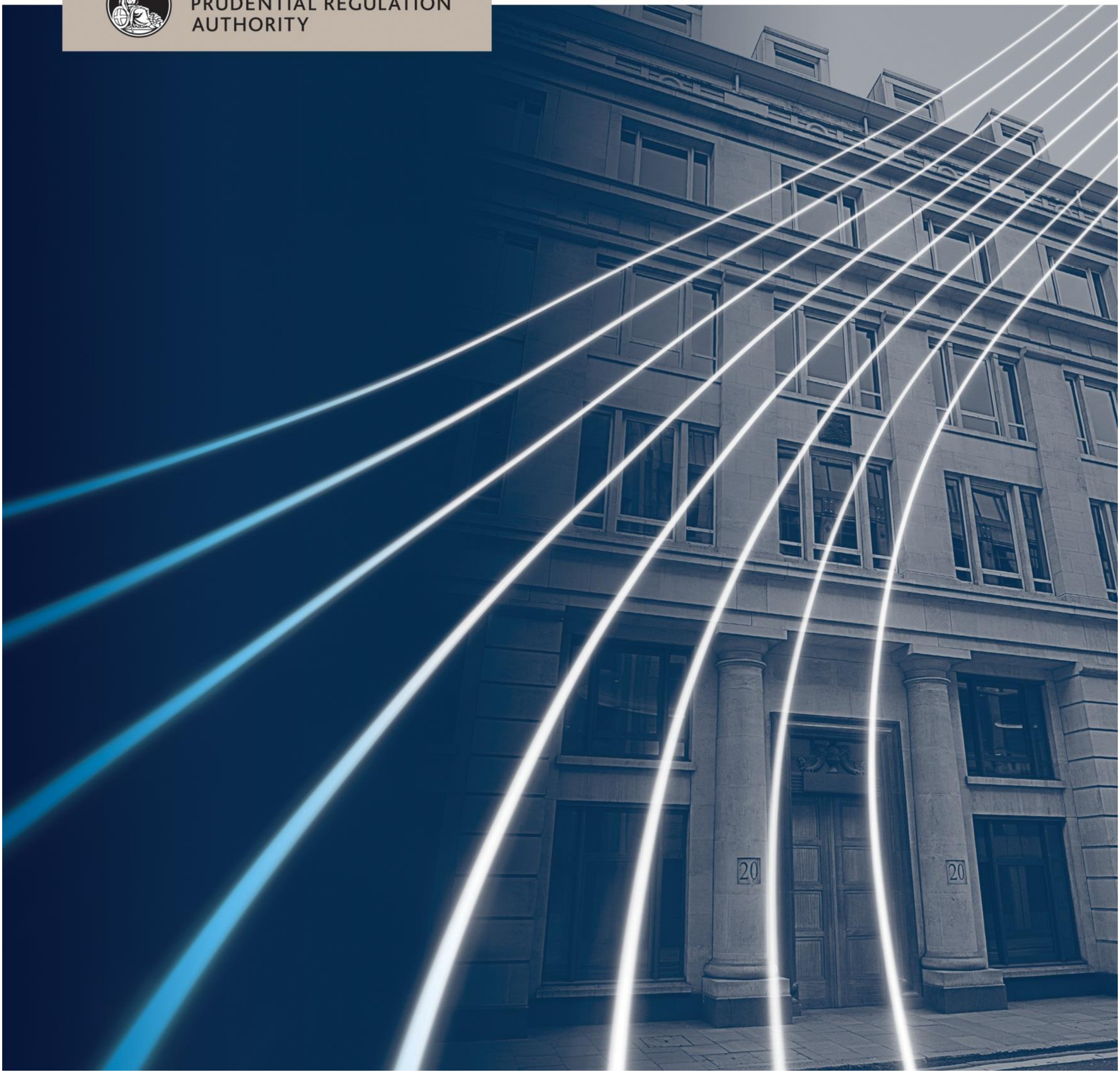
Policy Statement | PS11/17

Maintenance of the ‘transitional measure on technical provisions’ under Solvency II

April 2017

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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1 Overview

1.1 This Prudential Regulation Authority (PRA) policy statement (PS) provides feedback to responses to Consultation Paper (CP) 47/16 'Maintenance of the 'transitional measure on technical provisions' under Solvency II'[1] and an updated Supervisory Statement (SS) 6/16.

1.2 It sets out final policy intended to clarify the PRA's expectations for maintaining the calculation of the transitional measure on technical provisions ('TMTP') both at outset and over the transitional period.

1.3 This statement is relevant to all UK insurance firms within the scope of Solvency II and to the Society of Lloyd's. It is particularly relevant to firms that have been granted approval to use the TMTP, or those considering applying to use this transitional measure.

1.4 In CP47/16, the PRA proposed amending SS6/16 'Recalculation of the 'transitional measure on technical provisions' under Solvency II' to include the PRA's expectations:

- that changes in best estimate assumptions used to calculate Solvency II technical provisions should, where applicable, be reflected consistently in the Solvency I Pillar 1 and Pillar 2 bases;
- that firms should analyse the material components and drivers of the TMTP benefit to facilitate better risk management; and
- on the role of firms' audit committees in ensuring that the TMTP claimed continues to meet the conditions for approval.

1.5 The PRA has made changes to the draft SS6/16 after considering responses to the consultation and further analysis. Details of the changes are included in Chapters 2 and 3 respectively, along with an assessment of the impact on firms. The PRA does not consider the impact of the changes to be significant.

2 Feedback to responses

2.1 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to consider representations that are made to it when consulting on its general policies and practices and its response to them.[2]

2.2 The PRA received four responses to the CP. Respondents were generally supportive of the proposed update but did raise several specific issues and questions regarding the details of the proposals. The PRA's feedback to the responses and final decisions are set out below following the same structure as the CP.

2.3 In the PRA's opinion, as set out in this chapter and Chapter 3 below, the changes to the consultation proposals are not significant and do not give rise to significant costs for firms.

Consistency of the Solvency I and Solvency II bases

2.4 Respondents requested clarification of whether, in the situation where a firm only applies TMTP to a subset of its eligible liabilities, the maximum TMTP should be calculated with

1 December 2016: www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp4716.aspx.
2 Sections 138J(3), 2L, and 138J(4).

respect to only those Homogenous Risk Groups (HRGs) which will be applying TMTP. The PRA confirms that this was the policy intention in the draft SS, and has now updated the wording in paragraph 3.1 of the final SS to reflect this.

2.5 One respondent proposed that where a difference between Solvency I and Solvency II assumptions has arisen due to feedback from the PRA, this difference should be eligible for inclusion in the TMTP and amortised over the full 16-year run-off period.

2.6 The PRA’s view, as set out in the SS (paragraph 3.3), remains that the TMTP should only be used to phase in genuine differences in the valuation methodology between Solvency I and Solvency II, and not to mitigate the effect of any strengthening of a firm’s best estimate valuation basis at or subsequent to the implementation of Solvency II.

2.7 As new information becomes available and operating conditions change, the PRA’s view of the risks faced by firms may evolve over time irrespective of whether the PRA is looking at a firm’s position measured on a Solvency I or Solvency II basis.

2.8 Respondents suggested minor amendments to paragraphs 3.3 to 3.5 of the SS, covering changes to best estimate assumptions. The PRA agrees with these suggestions and has updated the final SS.

Recalculation of the transitional measure

2.9 A respondent requested clarification of whether the financial resource requirement (‘FRR') test should include business written after the introduction of Solvency II. The PRA has therefore confirmed in paragraph 4.19 of the SS that the FRR test should be applied considering the financial resources requirements for all of the business of the entity, not just the business written prior to the introduction of Solvency II. Nevertheless, a firm may be able to use just the business written before the introduction of Solvency II as part of a proxy calculation (for the business written after), as long as it can demonstrate why using this methodology is appropriate and does not result in a materially different outcome to a full calculation.

2.10 Solvency II allows for a recalculation of the transitional measure every 24 months without further conditions; respondents queried whether a formal application would be necessary for these recalculations. The process for this recalculation will be directly communicated to firms later in 2017 ahead of the first 24-monthly recalculation, which is expected to take place for all firms. Paragraph 4.21 of the SS clarifies that firms that have recalculated their transitional measure shortly before the end of a 24-month period would not be expected to carry out the regular recalculation if the resulting change would be minimal.

2.11 Respondents were supportive of the expectation in paragraph 4.24 of the SS that a firm’s audit committee should form an independent view on whether or not the firm meets the conditions to apply TMTP as set out in Regulation 54 of the Solvency 2 Regulations 2015 (2015/575) (‘The Solvency 2 Regulations 2015’).[1]

2.12 Two respondents highlighted the need for a simplified application process for TMTP recalculation, particularly given the volatility of the risk margin. The PRA can confirm that it is currently engaging with stakeholders to identify possible process simplifications.

1 March 2015: www.legislation.gov.uk/uksi/2015/575/pdfs/uksi_20150575_en.pdf.

3 Additional changes

3.1 This section sets out other amendments to the proposals consulted on in the CP, following further PRA analysis. The PRA considers that the changes should not place undue burden on firms.

Timeliness of applications for recalculation

3.2 To enable firms to reflect up-to-date TMTP numbers in their reporting, the PRA has set out in paragraph 4.5 of the SS, its expectation regarding the timeliness of a firm's application for TMTP recalculation after a material change in risk profile occurs. Where a firm has knowledge of an upcoming material change in risk profile, it should engage early with the PRA to ensure that an application for TMTP recalculation can be considered by the PRA on a timely basis. For changes in risk profile due to changes that could not have been anticipated (for example in relation to operating conditions), the PRA expects firms to apply for recalculation as soon as is feasible and not normally more than three months following the risk profile change. Finally, the PRA does not expect a firm to apply for a recalculation effective from a given date if the firm has since publicly reported its Solvency II numbers, as at that or a later date, using the un-recalculated TMTP amount.

3.3 The PRA considers that three months is an adequate amount of time for a firm to become aware of a material change in risk profile's having occurred, and to take action. In a scenario where three months is insufficient, the PRA will take the mitigating circumstances into account when assessing the application. The PRA does not expect this timeframe to cause a significant burden for firms.

Amount of TMTP applied by a firm

3.4 The Solvency 2 Regulations 2015 prescribe the amount of the transitional deduction to be applied by a firm to be between zero and a maximum amount. The PRA has clarified in paragraph 4.22 of the SS that if a decision is taken by a firm to apply less than the maximum amount, the PRA expects the firm to have a transparent approach to determining the level of benefit to apply, to reflect the approach within its risk management framework and Own Risk and Solvency Assessment (ORSA) and to follow it consistently.

3.5 The PRA has emphasised in paragraph 4.23 of the SS its expectation that a firm's disclosure of its solvency ratio to the market will not include an allowance for TMTP that is greater than the maximum amount at that date for which PRA approval has been obtained. A firm may opt to provide supplementary information using its own management estimate of a notional amount of TMTP which fully reflects operating conditions at the reporting date, but for which PRA approval has not been granted. The PRA recommends that any firm providing this information should disclose the approach taken and follow it consistently, as set out in paragraph 3.4 above.

3.6 The PRA has taken into account the potential effect on firms of these clarifications and believes that the associated incremental cost to firms will be minimal.

Appendix

1 Supervisory Statement 6/16 'Maintenance of the 'Transitional Measure on Technical Provisions' under Solvency II' UPDATE available at www.bankofengland.co.uk/pra/Pages/publications/ss/2017/ss616update.aspx.