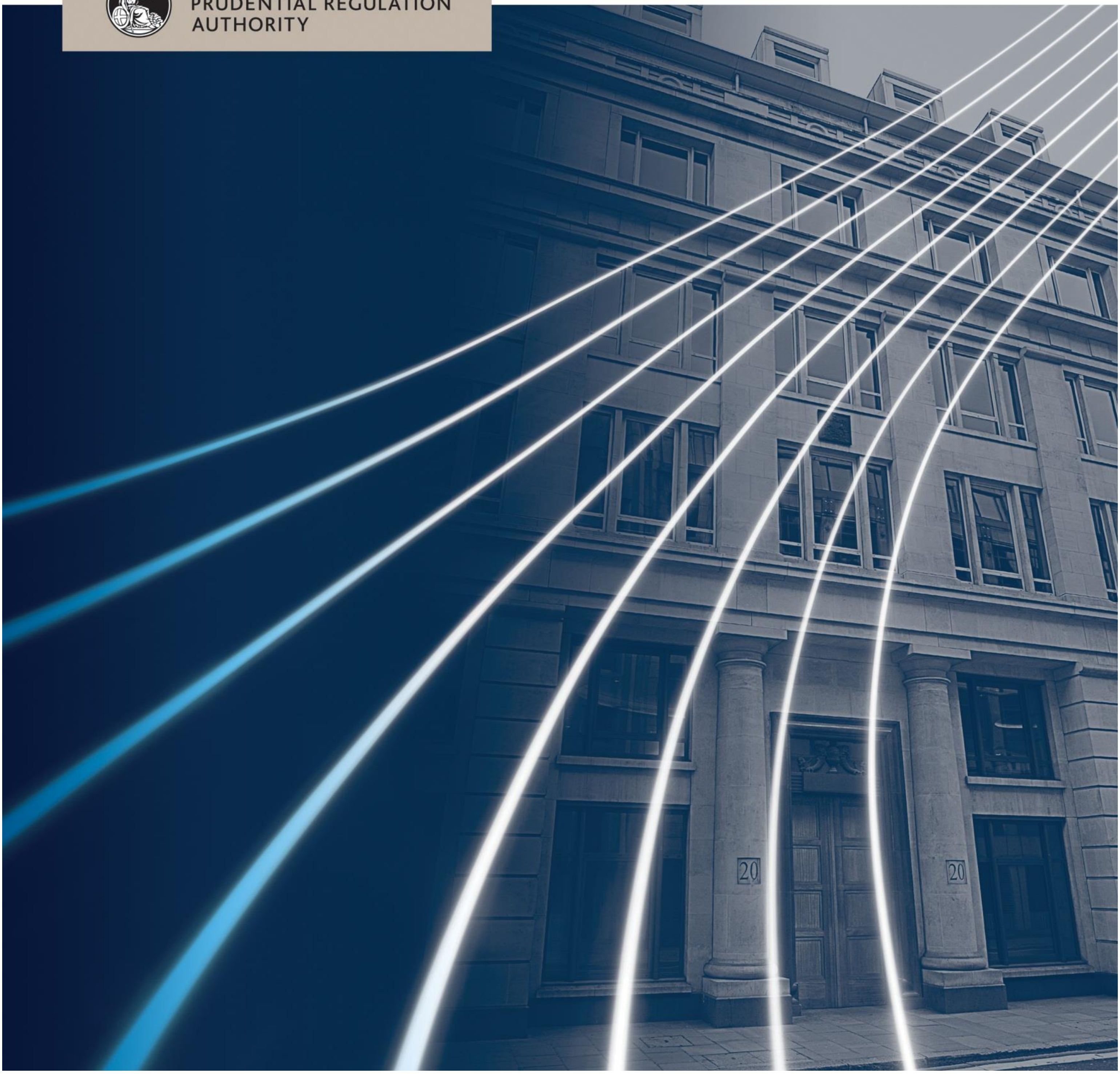
Policy Statement | PS22/18

Solvency II: Supervisory approval for the volatility adjustment

October 2018

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 22/17 'Solvency II: Supervisory approval for the volatility adjustment'.[1] It also contains the PRA's updated Supervisory Statement (SS) 23/15 'Solvency II: supervisory approval for the volatility adjustment'[2] (link also available in Appendix).

1.2 This PS is relevant to insurance and reinsurance companies using or intending to use the volatility adjustment.

Background

1.3 In CP22/17 the PRA proposed to clarify its expectations in respect of insurance and reinsurance firms seeking approval to apply a volatility adjustment (VA).

1.4 In the course of reviewing firms' VA applications the PRA identified particular areas of prudential risk that may have arisen from use of the VA, and which have had to be addressed in the review process. The CP aimed to alert all firms considering applications to use the VA to those risks and to help them to produce high-quality applications that successfully address those risks.

Summary of responses

1.5 The PRA received five responses to the CP. Respondents made a number of observations and requests for clarification which are set out in Chapter 2.

Changes to draft policy

1.6 After considering the responses, the PRA has made some changes to the draft policy. Details of the changes are included in Chapter 2. The PRA does not consider these to change the substance of its expectations. They provide additional clarification where requested, with one more substantive change to the endorsement of the application of the VA to make the process more streamlined. The PRA does not consider the impact of changes for firms as significant, or that it is any different in respect of mutuals.

Implementation

1.7 The expectations set out in the attached SS will come into effect on the publication of the PS on Wednesday 17 October 2018.

1.8 The policy contained in this PS has been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including changes arising once any new arrangements with the European Union take effect.

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1 November 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-supervisory-approval-for-the-volatility-adjustment.

2 https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-supervisory-approval-for-the-volatility-adjustment-ss.

2 Feedback to responses

2.1 The PRA must consider representations that are made to it in accordance with its duty to consult on its general policies and practise, and must publish in such manner as it thinks fit responses to the representations.[3]

2.2 The sections below have been structured broadly along the same lines as the chapters of the CP, with some areas rearranged to respond better to related issues. The responses have been grouped as follows:

- dynamic volatility adjustment (DVA);
- approval;
- content of the VA application;
- intended purpose of the VA;
- under-valuation of financial guarantees;
- own risk and solvency assessment (ORSA);
- earning the VA in practice; and
- alignment with the Treasury Select Committee (TSC) report.

Dynamic volatility adjustment (DVA)

2.3 Three respondents commented that the PRA should allow for the dynamic nature of the VA when calculating the solvency capital requirement (SCR) using an internal model.

2.4 In April 2018 the PRA published a separate consultation (CP9/18 'Solvency II: Internal models – modelling of the volatility adjustment')[4] that set out the PRA's proposal to consider applications from internal model firms that include a DVA. It set out the PRA's expectations of internal model firms when determining the risks that might arise from the DVA when calculating the SCR. PS23/18 'Solvency II: Internal models – modelling of the volatility adjustment' in response to CP9/18 has been published separately.[5]

Approval

2.5 The main purpose of SS23/15 'Solvency II: supervisory approval for the volatility adjustment' was to set out the PRA's expectations of firms applying for permission to apply the VA.

2.6 One respondent asked for a more comprehensive review of the approval process. This respondent challenged the need for prior regulatory approval, and further challenged the VA approval timescale and the rigidity of the process. They also queried the possibility of allowing

3 Sections 2L and 2N of the Financial Services and Markets Act (FSMA).
4 See page 2 of 2: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-internal-models-modelling-of-the-volatility-adjustment.
5 See page 1 of 2: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-internal-models-modelling-of-the-volatility-adjustment.

an 'emergency' VA approvals process to expedite approvals in times of stress, arguing that this could help avoid crowd behaviour and support countercyclical reaction to sharp spikes in spreads.

2.7 The UK has adopted the Member State option to require prior VA approval, with conditions for approval set out in The Solvency II Regulations 2015. The appropriateness of adopting this option was out of scope for CP22/17. Regarding the respondents' suggestion that an 'emergency' VA process should be designed, the PRA refers to Article 28 of the Solvency II Directive which already indicates that in the course of exercising its supervisory duties the PRA should consider the potential impact of its decisions on the stability of the UK financial system taking into account the information available at the relevant time (including emergencies). This is aligned with the PRA's safety and soundness objective. The PRA already takes a proportionate approach to reviews, expediting simpler applications and focusing on more complex ones, and has to date approved applications of a wide range of life and non-life insurance products. The PRA does not consider that it is necessary to establish an emergency VA mechanism as the current approval process is already capable of responding quickly if it is appropriate to do so.

2.8 Nevertheless the PRA has considered the appropriateness of a more straightforward application process and agrees that the multiple sign-offs proposed in paragraph 2.4 of SS23/15 created a more cumbersome process than necessary. Accordingly the PRA has modified that paragraph as described below.

Content of the VA application

2.9 In CP22/17 the PRA proposed that a firm's governing body should seek advice from a relevant Senior Insurance Manager to strengthen the governance surrounding the application. The PRA proposed the addition of a supplementary expectation to the final bullet point in paragraph 2.4 of the SS that a firm's governing body seek advice from relevant Senior Insurance Managers and the Actuarial Function (within their existing responsibilities) as part of endorsing the VA application.

2.10 Two respondents challenged the requirement to obtain advice both from the Actuarial Function and from the Chief Actuary. They believe that this is likely to lead to duplication where the Chief Actuary leads the Actuarial Function. They also believe the advice sought by the governing body should be at their discretion and they should seek advice from those who they deem to be appropriate.

2.11 SS23/15 currently states that firms' boards should submit a cover letter for VA applications, stating that the board endorses the application and that in their view the statutory approval conditions are met. In the interests of a more straightforward VA application process the PRA has incorporated the feedback from the respondents and the PRA ask that the application is now endorsed by the senior manager who is responsible for the ORSA that is presented to the firm's governing body.

2.12 Therefore the PRA has amended the final bullet point in paragraph 2.4.

Intended purpose of the VA

2.13 The PRA proposed a new Chapter 2A to set out the VA's intended purpose. The PRA considered that the VA is a tool designed to mitigate rather than increase firms' exposure to artificial balance sheet volatility and to help eliminate the need for insurers to engage in pro-cyclical investment behaviour. Using the VA in a way that is not aligned with its intended purpose could give rise to undue capital relief. The PRA therefore proposed that firms should consider, before submitting an application, whether the application is consistent with the intended purpose of the VA.

2.14 All the respondents commented that paragraph 2A2 needed additional clarity. They felt that the sentence ‘the purpose of the VA is not to help smooth volatility in the SII balance sheet arising from movements in the risk-free rate’ was at odds with the sentence ‘the VA aims to mitigate ‘artificial’ balance sheet volatility caused by short-term market volatility in the value of assets’ since the latter can be caused by the former.

2.15 One respondent further commented that they believe paragraph 2A2 is inconsistent with the Solvency II Directive which states ‘in order to prevent pro-cyclical investment behaviour, insurance and reinsurance undertakings should be allowed to adjust the relevant risk-free interest rate term structure for the calculation of the best estimate of technical provisions to mitigate the effect of exaggerations of bond spreads.’

2.16 Another respondent made the following more specific comments:

(i) the size of credit spreads and hence the VA is not wholly independent of volatility in the risk free rate;

(ii) as the VA is an adjustment to the risk-free rate it is likely to alter the sensitivity of an insurer's balance sheet to changes in the risk-free rate and this alone should not be seen as a reason not to grant the VA; and

(iii) it is unlikely that many insurers would use the VA predominately to hedge against changes in the risk-free rate, since the VA does not move in line with the risk-free rate.

2.17 Paragraph 2A2 aims to remind firms that the purpose of the VA is ‘to mitigate the effect of exaggerations of bond spreads’ (from Recital 32 of Omnibus II Directive). Spreads are calculated with reference to the risk-free rate. The VA is not in place to mitigate the volatility due to asset price movements in the risk-free rate, if these do not entail exaggerated bond spreads. As noted above, if a firm applies a VA for business that is not backed by spread-sensitive assets this can create rather than reduce artificial balance sheet volatility. If a firm is not holding spread-risky assets (or assets highly correlated with spreads) to cover its insurance liabilities then it is not exposed to short term volatility in the prices of the assets that cover its liabilities due to spread movements. Such a firm may be exposed to asset price movements that are driven by changes in the risk free rate – but the VA is not intended to mitigate those changes. Such use of VA is not compatible with good risk management since it will give capital relief in a situation where it is not needed (as noted in 2A3) and may increase rather than decrease balance sheet volatility.

2.18 To make the point clearer the PRA has made changes to paragraph 2A2.

2.19 All respondents comment that it would be helpful if the PRA could clarify paragraph 2A3 that stated ‘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 the balance sheet, such as the risk of future loss of own funds if the VA reduces in size. And it may suggest that the firm’s risk profile deviates from the assumptions underlying the VA' and suggest circumstances where the PRA would regard capital relief as being undue.

2.20 The PRA is required under Article 77f of the Solvency II Directive to assess (and report to the European Insurance and Occupational Pensions Authority (EIOPA)) information about firms that may be deriving undue capital relief from the VA. Paragraph 2A2 clarifies the PRA's view as to the intended purpose of the VA, and if applied appropriately should not give undue capital relief.

Under-valuation of financial guarantees

2.21 Using the VA to value financial guarantees may pose particular challenges for firms. The PRA proposed that firms consider the appropriateness of the valuation bases used for risk management purposes, independently of whether the VA is used. The PRA proposed introducing new paragraphs 3.8A and 3.8B to clarify the PRA's expectations for firms valuing and managing risks associated with financial guarantees.

2.22 One respondent commented that these new paragraphs in the SS were unclear. Firms are likely to consider appropriateness of actions on a range of bases, including regulatory which allows for VA. They believe that understanding the impact of a regulatory basis of a management action is good risk management, and would like confirmation that there is no intention to prevent this.

2.23 The PRA recognises that the regulatory basis is reasonable in some risk function assessments. However, if firms adjust the risk-free rate used in their valuation models to include the VA this may result in a cost of guarantees that is inappropriate for other risk assessments, eg the deployment of risk mitigation techniques such as full or partial hedging of exposures, or the setting of surrender charges. Hence paragraph 3.8C highlights that for those applications firms should use appropriate valuation bases which may differ from those in the regulatory balance sheet.

Own risk and solvency assessment (ORSA)

2.24 The PRA proposed additions to part of paragraph 3.8E in the SS explaining that firms should consider 'any material basis risk that results from divergences between the assets they hold and those underlying EIOPA reference portfolio'. Furthermore paragraph 3.9 states firms should '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 is submitted'.

2.25 One respondent commented that the PRA should clarify what additional assessment is required in respect of the consideration of basis risk in the last sentence of paragraph 3.8E.

2.26 The intention common to both 3.9 and the last sentence of 3.8E is for firms to reflect any basis risk they are exposed to, to be reflected in the ORSA. The PRA agrees that the broader expectation set out in paragraph 3.9 overlaps with the last sentence of paragraph 3.8E and hence the PRA has removed the following from 3.8E 'and any material basis risk that results from divergences between the assets they hold and those underlying the EIOPA reference portfolio'.

Earning the VA in practice

2.27 If a firm does not earn a yield of the risk-free rate plus VA from the assets that it actually invests in to cover its liabilities, but has already taken credit for this yield upfront through its use of the VA, then it will have to draw on its surplus assets to fund the shortfall. To mitigate the risk, the PRA proposed amending paragraph 3.9 of SS23/15 to include more detail about the need to compare the yield on the firm's assets with the yield implicitly assumed in the discount rate, and to manage any risk that this yield does not emerge in practice.

2.28 Two respondents commented that the wording in paragraph 3.9 lacks clarity and are looking for more explicit confirmation of situations where this applies. They make the assertion that assets a firm 'intends to hold in future, following the investment of future premium income or asset maturity proceeds' and 'assets they intend to purchase at a future date' implies that a VA application can be made on policies where there might currently be no physical backing assets (eg due to a negative best estimate liability), but where there would be such assets in future.

2.29 The SS clarifies that for any assets with an uncertain return (such as assets that offer sufficient yield now but will mature and need to be reinvested before the liabilities expire, or assets that need to invest some of the future premium income and this will be invested at an unknown future rate and; assets that offer an uncertain return such as equities) – the firm must be able to demonstrate that they can manage any risk that the additional yield does not emerge in practice. The PRA cannot refer to specific cases in the SS; each situation will be assessed on its own merits with more in-depth reviews carried out where the PRA perceives greater uncertainty of future returns or higher reinvestment risk, which may be higher in cases where there are no assets currently backing liabilities. For additional clarity some examples of what the PRA mean by 'intends to hold in future' are: the firm chooses to invest in assets that offer sufficient yield now, but will mature (and so need to be reinvested) before the liabilities have expired; or the firm will need to invest some of its future premium income, at an unknown future rate, in order to cover its future liabilities.

Alignment with Treasury Select Committee (TSC) report

2.30 The TSC published a report on Solvency II in October 2017.[6] On the VA the report suggested developing proposals for the VA which allow more flexibility and a more principles-based approach, and which reduce the requirement for insurers to develop complex structures in order to achieve the regulatory treatment that they warrant.

2.31 Two respondents have both commented that the CP is limited in light of the TSC report and fails to tackle the issues identified in the report.

2.32 The PRA has limited scope to change Solvency II. However, as noted in the PRA's response to the Treasury Committee's inquiry into Solvency II, the PRA is committed to making improvements to its implementation of Solvency II where appropriate, and where the PRA has discretion to do so.[7] For the VA the UK has exercised the option to require prior supervisory approval. Approval aims to reduce the risk that the risks that arise from use of the VA are detrimental to policyholders. The PRA's principles-based approach has meant that it has been

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6 'The Solvency II Directive and its impact on the UKI Insurance Industry': https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/324/324.pdf.

7 'PRA response to the Treasury Committee's inquiry into Solvency II', February 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-response-to-the-treasury-committees-inquiry-into-solvency-2.

able to be flexible when assessing firms' applications, and has approved applications from firms to use the VA for various types of business (eg with-profits business and shorter-tailed non-life business).

2.33 The PRA recognises that an important part of the TSC inquiry related to the use of the dynamic VA in internal models, which is an area addressed in a separate consultation with the PRA's policy finalised in a separate PS.[8]

8 PS23/18 'Solvency II: Internal models – modelling of the volatility adjustment', October 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-internal-models-modelling-of-the-volatility-adjustment.

Appendix

SS23/15 'Solvency II: supervisory approval for the volatility adjustment', available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-supervisory-approval-for-the-volatility-adjustment-ss.