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Policy Statement | PS12/21

Solvency II: Deep, liquid and transparent assessments, and GBP transition to SONIA

June 2021

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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

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1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 1/21 'Solvency II: Deep, liquid and transparent assessments, and GBP transition to SONIA'.[1] It also contains the PRA's final policy, as an updated Statement of Policy (SoP) 'The PRA's approach to the publication of Solvency II technical information' (Appendix 1).[2]

1.2 This PS is relevant to all UK Solvency II firms, including in respect of the Solvency II groups provisions, and to the Society of Lloyd's and its managing agents (hereafter referred to as UK insurers). Non-Directive firms are out of the scope of this PS.

Background

1.3 Since 11pm on Thursday 31 December 2020, the PRA has been required to publish Solvency II technical information (TI) for each relevant currency, including the basic risk-free rates (RFRs) and fundamental spreads (FSs) used in the calculation of the Matching Adjustment (MA) and Volatility Adjustment (VA).[3] The RFRs must be based on financial instruments traded in a deep, liquid, and transparent (DLT) financial market.[4]

1.4 The Solvency II TI for some currencies, including GBP, currently references Libor swap rates. Since the global financial crisis in 2008-09, activity in the markets that Libor measures has reduced. The low volume of underlying transactions means that Libor is no longer sustainable and has put its future viability in doubt.[5] In December 2020, the administrator of Libor, ICE Benchmark Administration, published a consultation on its intention for the GBP, JPY, and some USD Libor panels to cease at end-2021, and for the remainder of USD panels to cease at end-June 2023.[6] In March 2021, the Financial Conduct Authority (FCA) confirmed that most Libor panels would cease immediately after Friday 31 December 2021.[7]

1.5 The Working Group on Sterling Risk-Free Reference Rates (RFRWG) has recommended that the Sterling Overnight Index Average (SONIA) be used as the preferred replacement for Libor for Sterling markets. The SONIA benchmark rate is a robust alternative to Sterling Libor and is administered by the Bank of England.[8]

1.6 The TI for GBP needs to be updated before the end of 2021 to reference SONIA Overnight Index Swap (OIS) rates. The TI for JPY and USD, the two other PRA-relevant currencies affected by Libor transition, will also need to be updated in due course.

1.7 In CP1/21, the PRA proposed to:

- retain the European Insurance and Occupational Pensions Authority's (EIOPA's) broad approach to DLT assessments for all relevant currencies, with some changes to allow an increased range of data and information sources to inform the assessments;

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1 January 2021: https://www.bankofengland.co.uk/prudential-regulation/publication/2021/january/solvency-ii-deep-liquid-and-transparent-assessments-gbp-transition-to-sonia.
2 December 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/the-pras-approach-to-publication-of-sii-technical-information.
3 December 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/the-pras-approach-to-publication-of-sII-technical-information.
4 Article 43 of the onshored Solvency II Delegated Regulation.
5 https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor.
6 https://www.theice.com/publicdocs/ICE_LIBOR_Consultation_on_Potential_Cessation.pdf.
7 https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf.
8 https://www.bankofengland.co.uk/markets/sonia-benchmark.

- calculate the GBP RFR using SONIA OIS rates for TI published with a reference date from and including Saturday 31 July 2021, and to conduct a DLT assessment of the SONIA OIS market to support this. It also proposed to publish indicative SONIA OIS-based curves before the transition date;

- retain the historical spreads (over the Libor-based RFR) already embedded in the Long Term Average Spread (LTAS) component of the FS, rather than restating them as spreads over SONIA OIS rates;

- allow for the impact of the transition of the GBP RFR from Libor to SONIA OIS to be eligible, in principle, for transitional relief (eg via the transitional measure on technical provisions (TMTP)); and

- not consider the updating of reference benchmarks for relevant assets within an MA portfolio as being a new feature of those assets, or as being a material change to an MA portfolio, meaning that firms would not need to make new MA approval applications solely to allow for those updates. Benchmark references would then be updated and included in any subsequent MA approval applications.

1.8 The PRA also stated within CP1/21 that:

- it regarded the credit risk inherent within SONIA OIS rates as negligible; and

- in line with internal model requirements, firms with approval to use partial or full internal models for interest rate risk should consider whether these models require updating to appropriately allow for the GBP RFR transition.

Summary of responses

1.9 The PRA received 10 responses to the CP. Respondents generally welcomed the PRA's proposals on DLT assessments, the publication of indicative SONIA OIS-based curves, the Credit Risk Adjustment (CRA) for SONIA OIS, the LTAS, the TMTP, MA applications, and internal models.

1.10 Some respondents noted the financial impact of the GBP RFR transition to SONIA OIS, and asked the PRA to consider smoothing this impact, by either:

- giving firms a window of time to make the change;

- introducing a new transitional measure;

- adding an 'upwards adjustment' to the SONIA OIS curve; or

- allowing an immediate recalculation of the TMTP at the transition date, regardless of whether the usual criteria for a recalculation were met.

1.11 There were also requests for clarification on some points. The PRA's feedback to both the smoothing proposals and the clarification requests are set out in Chapter 2.

1.12 Some responses expressed views about more fundamental aspects of the construction of Solvency II RFRs (such as the hierarchy of instruments to be used as inputs to the RFR curves, and the choice of interpolation methodology), and about the PRA's publication of TI, which were outside of the scope of the proposals in CP1/21. Those points are not addressed further here.

Changes to draft policy

1.13 The following minor changes have been made to the draft policy as proposed in CP1/21:

- insertion of a new paragraph 2.2 in section 2 of the SoP, referencing the section of the Bank of England website where the PRA publishes its TI;
- deletion of what was the proposed paragraph 3.6A of the SoP, since that information about the reference instrument for the GBP RFR is now available on the TI section of the website;
- insertion of new wording for paragraph 3.6A, explaining that the PRA will make relevant information available about any changes to the reference instruments and CRAs used to construct the basic RFRs for PRA relevant currencies, for example via the TI section of the Bank of England's website. The PRA will aim to give firms at least three months' notice of such changes;
- a change to paragraph 3.6D of the SoP, to explicitly state (rather than just cross-refer to) the volume indicators that the PRA will use to assess the liquidity of swap markets;
- a change to the wording of paragraph 3.6E of the SoP to better reflect the policy intention articulated in CP1/21 that the PRA will be guided by certain additional DLT assessment criteria as 'soft thresholds', which may need to be adapted to reflect the specific circumstances of individual markets; and
- a new paragraph break in what was the proposed paragraph 3.6E, and renumbering of the subsequent paragraphs.

1.14 These changes to the SoP aim to make the final policy clearer and do not result in any additional burden on firms compared to the original proposals. As a result, the PRA has not updated the cost benefit analysis. The changes to the draft proposals would not have a differential impact on mutuals compared to the original proposals.

Implementation and next steps

1.15 The new policy will take effect from the date of publication of this PS and updated SoP, Thursday 3 June 2021, except for the transition to the new GBP RFR, which will take effect in the publication of TI with reference dates from and including Saturday 31 July 2021. For the avoidance of doubt, this means that the GBP RFRs that the PRA will use when calculating daily spread figures (eg for the LTAS calculation) will be based on Libor swap rates for dates up to and including Wednesday 30 June 2021, and will switch to being based on SONIA OIS rates for dates from and including Thursday 1 July 2021.

DLT Assessments for GBP

1.16 A first DLT assessment of the SONIA OIS market has been conducted and the results have been published on the Bank of England website in parallel to publication of this PS (see Appendix 2). This DLT assessment will form the basis for determining the maturities (including the Last Liquid Point (LLP)) of the SONIA OIS market that will be used as inputs to the PRA's published GBP TI. The assessment has concluded that the LLP for SONIA OIS should be at 50 years.

Transition from JPY and USD Libor

1.17 CP1/21 stated that the JPY and USD TI references would transition from Libor swap to OIS rates, but the date and approach to those transitions would depend on the liquidity of swaps

referencing the Tokyo Overnight Average Rate (TONA) and the Secured Overnight Financing Rate (SOFR).

1.18 At the time of publication of this PS, markets referencing TONA are still in a relatively early stage of development, although activity is expected to increase during 2021. If markets referencing TONA are not sufficiently DLT to be used as the basis for a RFR curve by the time that the JPY Libor swap market ceases to be deemed DLT, Article 44 of the onshored Solvency II Delegated Regulation requires government bond rates from DLT markets to be used instead, adjusted to take account of the credit risk of the government bonds.

1.19 The PRA will continue to monitor liquidity in the JPY Libor and TONA swap markets, and assess to what extent these markets are DLT. The PRA will also make the necessary preparations to transition its JPY TI to reference JPY government bonds as the default position in the situation that no DLT JPY swap market is available.

1.20 Although JPY is a PRA relevant currency, the proportion of UK insurers' business that will be affected by the JPY TI transition is very small. The PRA intends to engage directly with materially-affected firms to understand any issues they may face relating to the transition and to ensure they have adequate time and information to prepare. The PRA will also continue to engage with EIOPA to understand its preparations for the transition of its own JPY TI. The PRA will then communicate the final implementation details for the transition in due course.

1.21 Cessation of most USD Libor settings is not due until Friday 30 June 2023. However, US supervisory authorities have been clear that use of USD Libor in new contracts should cease as soon as practicable, and no later than the end of 2021, subject to a relatively limited set of exceptions for risk management purposes.[9] The PRA will continue to monitor the level of market activity in swaps referencing USD Libor and SOFR and will confirm the implementation details for the USD RFR transition in due course.

Ultimate Forward Rates (UFRs)

1.22 On Wednesday 21 April 2021, EIOPA published the UFRs that will be used in the production of EIOPA's TI from Saturday 1 January 2022.[10] EIOPA's UFRs are determined using the same methodology as the PRA applies for its own TI. For 2022, the UFRs that the PRA uses when calculating its own TI will be the same as those published by EIOPA, and the PRA anticipates that this will also be the case in future years, absent any divergence in the UFR methodologies used.

EIOPA consultation on Interbank Offered Rate (IBOR) transition

1.23 On Friday 30 April 2021, EIOPA published a consultation paper on IBOR transition and how it would affect its publication of Solvency II TI.[11] Some of EIOPA's proposals may lead to future divergence between the PRA's and EIOPA's TI if they are implemented (noting that as they are consultation proposals at present, the final approach may differ). EIOPA proposes to use SONIA OIS rates with zero CRA as the future basis for its GBP RFR curve (in line with the PRA), but has not proposed a fixed date for the transition to take place. Instead EIOPA proposes to determine the transition date with reference to (i) the proportional share of SONIA OIS trades versus Libor swap trades; and (ii) the size of the difference between the Libor swap and OIS curves, relative to its historical levels. EIOPA has also made proposals about the transition approach for JPY and CHF (where it expects to reference government bonds in the first instance, given the current low level of

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9 https://www.federalreserve.gov/supervisionreg/srletters/SR2107.htm.
10 https://www.eiopa.europa.eu/content/calculation-of-ultimate-forward-rate-2022_en.
11 https://www.eiopa.europa.eu/content/consultation-proposal-ibor-transitions_en.

liquidity in the relevant OIS markets) and the determination of the LLP for various currencies following IBOR transition. EIOPA expects the LLP for GBP to reduce from 50 to 30 years when it carries out a first DLT assessment of the SONIA OIS market, whereas the PRA's own assessment has concluded that the LLP for GBP should remain at 50 years. EIOPA's consultation will close on Friday 23 July 2021.

Review of Solvency II

1.24 On Tuesday 23 June 2020, the Government announced its intention to review certain elements of Solvency II. On Monday 19 October 2020, HM Treasury launched a Call for Evidence for the review. The Call for Evidence included a section on the GBP RFR transition, asking for views on factors that should be considered as part of the transition, and on its timing.[12] The Call for Evidence closed on Friday 19 February 2021, and the PRA has supported HM Treasury in reviewing the responses.

1.25 The proposals set out in this PS have been designed in the context of the UK having left the European Union and the transition period having come to an end. Unless otherwise stated, any references to EU or EU derived legislation refer to the version of that legislation which forms part of retained EU law.[13] The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework.

12 https://www.gov.uk/government/publications/solvency-ii-review-call-for-evidence.
13 For further information, please see https://www.bankofengland.co.uk/eu-withdrawal/transitioning-to-post-exit-rules-and-standards.

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 practices and must publish, in such manner as it thinks fit, responses to the representations.

2.2 The PRA has considered the responses received to the CP. This chapter sets out the PRA's feedback to those responses, and its final decisions.

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

- the DLT Assessment Process;
- transition from GBP Libor swap rates to SONIA OIS rates, including determination of the CRA;
- impact on transitional measures for business written before 2016; and
- impact on firms with approval to apply the MA and to use an internal model for determining their Solvency Capital Requirements (SCRs).

The DLT Assessment Process

General methodology

2.4 In CP1/21, the PRA proposed to maintain the results of EIOPA's DLT assessments during 2021, and proposed how it would carry out its own annual DLT assessments for application in future years. This included the proposal that the PRA would be guided by some 'soft thresholds' when determining if a market had newly become (il)liquid, but that these thresholds may need to be adapted to reflect specific circumstances of individual markets.

2.5 Respondents agreed with the approach proposed in the CP. One respondent asked the PRA to give firms at least a three-month notice period of any changes to the published TI following a DLT assessment. Another respondent asked the PRA for more clarity about the circumstances in which the 'soft thresholds' might be adapted.

2.6 The PRA has not yet decided on the most appropriate publication and implementation schedule for its own annual DLT assessments for PRA-relevant currencies. However, in determining this schedule, the PRA will aim to ensure that firms have reasonable notice of any change to the published TI following an annual DLT assessment.

2.7 The 'soft thresholds' state that a previously liquid market needs to drop at least 20% below one of the usual DLT thresholds to be considered illiquid, and a previously illiquid market must meet both of the usual DLT thresholds and rise to at least 20% above one of the thresholds to be considered liquid. They are intended to prevent undue volatility in the results of a DLT assessment by ensuring that any judgement that a previously illiquid market has become liquid (or vice versa) is not prompted purely by a small fluctuation in one of the indicators that may later reverse. When deciding how to apply the soft thresholds to a particular market, the PRA might, for example, consider whether there are external factors influencing that market which make any apparent increase or decrease in liquidity more likely to be sustained rather than the result of a short-term fluctuation. The more that an increase or decrease in liquidity can be observed to represent a

sustained trend, the less the PRA will need to rely on the soft thresholds as a means of minimising undue volatility in the DLT results.

2.8 The PRA has made some small changes to the SoP wording on the DLT assessment to improve its clarity, as set out in Chapter 1.

Approach to DLT assessment for SONIA OIS market

2.9 The PRA proposed that it would carry out a DLT assessment for the SONIA OIS market in the first half of 2021, and that in the context of the particular circumstances of the transition from Libor to SONIA, the assessment may need to be supplemented with other relevant data and the use of expert judgement.

2.10 Respondents supported the PRA using expert judgement to supplement observations of market data, particularly given that the SONIA OIS market is still developing and is likely to increase in depth and liquidity over time. In light of this, respondents supported the application of judgement to retain the LLP for GBP at 50 years, noting that a lower LLP would increase the influence of the UFR on some of the most material tenors of the curve, making hedging more difficult and introducing additional balance-sheet volatility.

2.11 The first DLT assessment for the SONIA OIS market (including any supplementary data and expert judgement that has been applied) has been published alongside this PS and can be found in Appendix 2.

Transition of the GBP RFR from Libor swap rates to SONIA OIS rates (GBP RFR transition), including determination of the CRA

Timing of the GBP RFR transition

Switchover date

2.12 The PRA proposed that the GBP RFR would be calculated using SONIA OIS rates for TI published with a reference date from and including Saturday 31 July 2021.

2.13 Two respondents said they supported this single switchover point; one of these noted that their asset transition programme was already well-advanced.

2.14 Three other respondents were in favour of a phased approach. One concern was that a single switchover point could incentivise insurers to migrate their remaining assets at this single point and that banks might then price against them.

2.15 The PRA considers that calculating the GBP RFR using SONIA OIS rates for TI published with a reference date from and including Saturday 31 July 2021 remains the most appropriate option and gives certainty for firms. Reflecting the GBP RFR change in the published TI from a single reference date onwards does not mean that the PRA expects all firms to complete their Libor transition programmes at or by this single date. Many firms are already well-advanced with their transition programmes and will have made further progress since CP1/21 was published.[14] If a firm acts ahead of (or after) the GBP RFR transition, this may imply carrying some basis risk, but since the difference

[14] The PRA wrote to CEOs of major banks and insurers in September 2018 to seek assurance that firms' senior managers and boards understood the risks associated with Libor transition and were taking appropriate action so that firms could transition to alternative rates ahead of the end of 2021. All firms with Libor exposures were encouraged to read the letter: https://www.bankofengland.co.uk/prudential-regulation/letter/2018/firms-preparations-for-transition-from-libor-to-risk-free-rates. The Bank of England sent a letter to banks and insurers in January 2020 setting expectations for transition progress during 2020: https://www.bankofengland.co.uk/prudential-regulation/letter/2020/next-steps-on-libor-transition.

between the Libor swap and SONIA OIS curves has been relatively stable for some time, this risk is likely to be manageable. Therefore, the PRA has not made any changes to the policy as proposed.

Publication of multiple curves in parallel, or guidance for firms to calculate their own curves

2.16 Two respondents asked the PRA to publish the old and new curves in parallel for a fixed window of time, and to allow firms to choose their own switchover date within this window. One of these respondents noted that a Statutory Instrument (SI) might be needed to allow the PRA to do this. A related suggestion was that the PRA could publish guidelines for firms and allow them to calculate their own curves.

2.17 A choice of RFRs, or the option for firms to produce their own RFRs, would hinder comparability between firms' reported Solvency II technical provisions. Furthermore, the Solvency II Regulations require the PRA to publish 'the relevant risk-free interest rate term structure' for each relevant currency.[15] The PRA considers this requires publication of a single curve per currency, so would not allow the PRA to publish multiple curves in parallel for a single currency and allow firms to choose between them.

2.18 PRA rules require firms to use the PRA's published TI (rather than their own alternatives).[16] These rules would preclude the PRA publishing guidance and allowing firms to calculate their own curves.

Publication of indicative curves

2.19 Several respondents supported the PRA's proposal to publish indicative SONIA OIS-based curves in the run-up to the GBP RFR transition, and asked for this to be done as soon as practicable. One respondent asked the PRA to publish any new data sources it intends to use for the SONIA OIS-based TI, including any new identification codes.

2.20 The PRA intends to publish, for reference purposes only, indicative GBP RFR curves based on SONIA OIS as soon as is practicable. For the avoidance of doubt, firms should not use these indicative GBP RFR curves for Solvency II reporting purposes. The PRA will also clarify any data sources and identification codes it uses for the SONIA OIS-based TI. The SoP has been updated to include a link to the TI section of the Bank of England's website, where this information will be made available.

Determination of the CRA

2.21 In CP1/21, the PRA stated that it regarded the credit risk in SONIA OIS rates as negligible.

2.22 Several respondents agreed with this assessment, stating that the CRA to the SONIA OIS-based curve should therefore be set to zero. Some respondents suggested that the onshored Delegated Regulation should be amended to allow for this by removing the formulaic calculation approach that includes a 10 basis point floor on the size of the CRA.

2.23 The PRA agrees that the CRA for the SONIA OIS curve should be zero, and has worked with HM Treasury on an SI to amend the relevant part of the Delegated Regulation. The SI removes the formulaic approach to determining the CRA, and allows the CRA to be zero where the financial instrument used to derive the basic risk-free interest rate contains negligible credit risk. The SI came into force on Friday 28 May 2021.[17]

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15 Regulation 4B of the Solvency 2 Regulations 2015/575.
16 Rule 3.1(1) in the Technical Provisions Part of the PRA Rulebook, read with the definition of 'relevant risk free interest rate term structure'.
17 The Solvency 2 (Credit Risk Adjustment) Regulations 2021.

Financial impact of the GBP RFR transition

2.24 Some responses discussed the financial impact of a transition to a SONIA OIS-based curve, versus a baseline of using the Libor-based curve less a CRA. One respondent expressed disappointment that the PRA had not included a quantitative impact estimate in CP1/21, and challenged the PRA's use of the word 'marginal' to describe the impact of the proposals on UK regulatory balance sheets.

2.25 The cost benefit analysis section of CP1/21 did not use the existing status (of a Libor-swaps-based curve, less a CRA) as the baseline for assessing the impact of the proposals it contained. This was because the cessation of Libor at the end of 2021 is happening independently of the proposals in the CP. The description of the impact of the CP proposals as 'marginal' referred only to the effect of the proposals for how and when (rather than whether) to implement the transition, such as: the choice of transition date; the date of next TMTP recalculation; the gradual change in the LTAS; and the decision to broadly align with EIOPA's DLT criteria. The CP explained this approach in paragraph 3.4.

2.26 One respondent asserted that the GBP RFR transition should be capital-neutral for firms because it is 'a technical change in the context of insurance business and not one brought about due to any specific risks or regulatory concerns relating to insurance business or risk management'. Libor benchmarks have long-standing weaknesses, and the PRA considers that replacement with a robust alternative will lead to an improvement in the transparency, prudence, reliability, and objectivity of insurers' technical provisions.

2.27 The PRA's engagement with UK insurers' Libor transition progress over the past several years means that the PRA has been aware for some time that the RFR transition would have a financial impact on firms. Several of the proposals in CP1/21 aimed to mitigate this impact, such as: the eligibility of the impact of the GBP RFR transition for transitional relief; and the proposal not to recalculate historical spreads when calculating the LTAS component for the MA and VA (both discussed later in this chapter). While these proposals would not benefit all firms equally, the PRA considers that they represent the extent of the feasible accommodations that can be made, while still achieving the imperative of replacing a Libor-based RFR with a robust alternative before the cessation of Libor at the end of 2021.

2.28 One respondent, a smaller mutual firm, expected a material impact partly because of their business model and partly because they did not currently benefit from measures such as TMTP, MA, and VA, which would be expected to help absorb the impact. Another respondent thought that the impact of needing to hedge against SONIA OIS movements would mostly affect with-profits policyholders.

2.29 The PRA recognises that the GBP RFR transition will affect each firm differently depending on its circumstances. The PRA will continue to collect data on the financial impact of the RFR transition on different firms, leveraging the upcoming data collections for the Solvency II Review. Any firm that believes the GBP RFR transition will have a material effect on the management of its regulatory solvency position should discuss this with its supervisor.

2.30 Nevertheless, the PRA considers that for the majority of firms any change in solvency coverage ratio will be relatively modest, and is unlikely to reach the 5 percentage point change that the PRA

has said it would expect to see from any firm applying for a TMTP recalculation on the grounds of a material change in risk profile.[18]

2.31 Having considered the responses related to the financial impact of GBP RFR transition, the PRA has not made any changes to the policy as proposed.

Proposal for a new transitional measure

2.32 One respondent noted that the TMTP would provide useful but temporary relief from the impact of the GBP RFR transition. However, another respondent noted that the TMTP would not help to offset the impact on business written after Friday 1 January 2016, and would not help offset SCR impacts, which the respondent considered could potentially be large for some firms with business lines such as guaranteed annuities and with-profits.

2.33 Three respondents asked whether the PRA could implement a new, separate transitional measure lasting at least ten years that would specifically target the balance sheet impact of the basic risk-free rate change, and that would apply to all business written before the change.

2.34 The PRA considers that legislating to introduce a specific new transitional measure specifically targeting the overall balance-sheet effect of the GBP RFR transition is undesirable because it would add complexity and use resources not proportionate to the scale of the change in the GBP RFR that it would be seeking to mitigate. A new transitional measure would also not be practicable in the time available, as it would require further legislative change.

Upwards adjustment to the SONIA OIS curve

2.35 Some respondents proposed that the PRA should make an 'upwards adjustment' to the SONIA OIS curve to produce the basic RFR for GBP, either on a transitional basis or permanently. This upwards adjustment was proposed to be fixed at 50% of the median differential between the Libor swap and SONIA OIS curves over a five-year period. (The use of a median over five years would align with the methodology used for the International Swaps and Derivatives Association (ISDA) fallback arrangement).

2.36 Respondents asserted that an adjustment would be appropriate because:

- using the pure SONIA OIS rate would be too conservative because insurers can earn more than this in a risk-free manner in practice (eg by investing in money market funds), due to the illiquidity of their liabilities. From this perspective, the Solvency II regime has historically reflected this via the 50% factor in the CRA formula, which could be seen as a policy choice allowing insurers to benefit from an illiquidity component in the difference between the six-month Libor/six-month OIS rates;
- using pure SONIA OIS rates could be counter to the competitiveness of the UK versus European insurance markets, since EUR liabilities would still be discounted using EURIBOR swap rates less a CRA; and
- it would mitigate the financial impact of the switch.

2.37 The PRA does not agree that a GBP RFR based on SONIA OIS rates should include an 'upwards adjustment'. EIOPA has stated the same view in its recent consultation paper on IBOR transition.

[18] May 2016: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/maintenance-of-the-transitional-measure-on-technical-provisions-under-solvency2-ss.

2.38 Not all insurers have illiquid liabilities, and those that do already have the option of applying for approval to augment the basic RFR with the VA or MA. Investments in money market funds or similar may offer a spread above the SONIA OIS rate, but this spread is likely to contain an element of credit risk, so cannot be earned by insurers in a risk-free manner in practice.[19]

2.39 The use of Libor swap rates minus a CRA was the best available proxy for a GBP RFR curve in 2014/15 when this part of the Solvency II framework was agreed. However, it has limitations. The drawbacks of Libor as a benchmark rate are well-known.[20] Rather than viewing the CRA methodology as implicitly containing policy choices not mentioned elsewhere within the Solvency II framework, the PRA considers that the CRA methodology was a compromise based on the limited OIS market data available from DLT markets in 2014/15 (when there was no well-developed market in longer-term OIS). The difference between short-term rates had to be used to derive a CRA that could apply sensibly across the whole term structure of the RFR curve. This was the reason for applying a 50% scaling factor (as well as averaging over one year and applying a cap and floor).

2.40 There is now a true close-to-risk-free benchmark rate in the form of SONIA, and there are SONIA OIS rates observable in markets that have depth, liquidity, and transparency that the Bank of England expects to equal that of Libor swaps.[21] These rates do not need a CRA to be applied, removing an element of complexity and approximation.

2.41 In terms of competitiveness, there are existing differences between the EUR and GBP risk-free curves, most notably in the determination of the LLP. The PRA considers that a robust GBP RFR curve, derived transparently and directly from the market rates of the most appropriate benchmark risk-free instruments, will not be detrimental to the relative attractiveness of the UK as a place to do insurance business.

2.42 Given the PRA's feedback above, the PRA is publishing the policy as proposed.

Impact of the GBP RFR transition on transitional measures for business written before 2016

2.43 The PRA proposed that the impact of the GBP RFR transition would be eligible, in principle, for transitional relief via the TMTP. Respondents welcomed this proposal. One respondent asked the PRA to confirm that the impact was also eligible for inclusion in the Transitional Measure on Interest Rates; the PRA confirms that this is the case.

2.44 Two respondents asked for guidance on how firms should calculate a 'pre-Solvency II' GBP RFR, if they had previously used GBP Libor swap rates for this purpose. The PRA is willing to consider all reasonable proposals for the construction of a proxy for the GBP Libor swap curve. The difference between the GBP Libor swap and SONIA OIS curves has been increasingly stable since the announcement of the ISDA fallback protocol.[22] Therefore, approaches that compute the size of this difference as at the date of the GBP RFR transition, and then apply this as an 'uplift' to the SONIA OIS curve going forward, are likely to result in an acceptable proxy.

2.45 The PRA stated that it would not generally expect firms to apply to recalculate TMTP purely on the basis of the GBP RFR transition, noting that for most firms the impact was not expected to

19 Article 43 of the onshored Solvency II Delegated Regulation requires that 'insurance and reinsurance undertakings are able to earn the rates [of the basic risk-free interest rate term structure] in a risk-free manner in practice'.
20 https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor.
21 https://www.bankofengland.co.uk/paper/2021/derivatives-clearing-obligation-modifications-to-reflect-interest-rate-benchmark-reform-amendments.
22 https://www.isda.org/protocol/isda-2020-ibor-fallbacks-protocol.

amount to a material change in risk profile (as per Supervisory Statement (SS) 6/16 'Maintenance of the 'transitional measure on technical provisions' under Solvency II'),[23] and that in any case a biennial recalculation was due at Friday 31 December 2021, five months after the transition date. One respondent was happy to wait until end-2021 for a TMTP recalculation, while some other respondents asked that an immediate recalculation of TMTP be allowed at Saturday 31 July 2021, even if the impact of the GBP RFR transition did not give rise to a material change in risk profile.

2.46 Having considered these responses, the PRA does not intend to depart from the expectation set out in SS6/16 that a firm applying for approval to recalculate TMTP needs to provide sufficient evidence of a material change in risk profile. However, when a firm assesses the ongoing appropriateness of its TMTP amount, and judges whether there has been a material change in risk profile since the date of the last recalculation, the PRA considers that in the period up to Saturday 31 July 2021, it would be reasonable for a firm to take a forward-looking view that encompasses how the risk profile is expected to evolve as a result of the GBP RFR transition.

Impact of the GBP RFR transition on firms with approval to apply the MA and internal models

Matching Adjustment

2.47 The LTAS is an input to the FS calculation for the MA and VA. The PRA proposed that the LTAS should recognise the change in spreads that results from the GBP RFR transition from the point of transition onwards, but that historic spreads already embedded in the LTAS calculation would remain unadjusted. Three respondents said that they supported this approach. As already mentioned in paragraph 1.15 above, for the avoidance of doubt, GBP spreads calculated for dates up to and including Wednesday 30 June 2021 will remain as spreads over Libor swap-based RFRs. GBP spreads calculated for dates from and including Thursday 1 July 2021 will be spreads over SONIA OIS-based RFRs.

2.48 Two respondents said that they supported the PRA's proposal that a new MA application would not be needed purely on account of updating references to benchmarks.

2.49 One respondent asked the PRA to clarify how any 'maximum make-whole spreads' previously expressed in terms of GBP Libor should be translated.[24] The PRA considers that translation approaches that make reference to the ISDA fallback protocol are likely to be an appropriate option, since these provide an existing widely-agreed means of translating between Libor and SONIA, and should preserve MA eligibility of previously-eligible assets. Any translated maximum make-whole spreads will need to continue to comply with the expectations set out in SS7/18 'Solvency II: Matching adjustment'.[25]

2.50 Although not mentioned in the CP, three respondents queried whether the PRA would amend the minimum deferment rate that applies for the purposes of the Effective Value Test in light of the GBP RFR transition.[26] The PRA considers that no amendment is needed. The minimum deferment rate is inherently meant to be a broadly stable parameter and not sensitive to small changes in real interest rates (hence the minimum step for deferment rate changes being set at 50 basis points).

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23 November 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/maintenance-of-the-transitional-measure-on-technical-provisions-under-solvency-2-ss.

24 Some assets in MA portfolios include clauses that compensate the investor in the event of a specified credit event. Firms' MA eligibility policies contain their own internal 'maximum make-whole spreads' to ensure that assets will only be included in the MA portfolio if their compensation clauses will provide 'sufficient compensation' to replace the foregone cash flows.

25 July 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-matching-adjustment-ss.

26 https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/solvency-ii/effective-value-test-parameters.

2.51 One respondent also asked that the PRA link the minimum deferment rate to SONIA OIS rates in future. The PRA confirms that OIS rates are already among the sources it uses to monitor movements in long-term real interest rates for the purposes of determining the minimum deferment rate.

Internal models

2.52 The PRA stated that, in line with internal model requirements, firms should consider the ongoing appropriateness of their internal models in light of the change to the GBP RFR.[27] One respondent asked the PRA to clarify that internal model changes made in order to reflect this change would be treated as minor, or else to commit to an expedited review process. The PRA considers that firms should assess any proposed model changes against their existing model change policies, and discuss the changes with their supervisory contacts in the first instance.

2.53 One respondent asked the PRA to clarify that firms' SCRs would not be expected to include basis risk capital in respect of temporary basis risk arising during a firm's Libor transition period. The PRA considers that the basis risk arising during a firm's Libor transition period will depend on its particular plans and risk profile. Internal models must allow for all material quantifiable risks.[28] Therefore, each firm with approval to use an internal model should consider the extent to which temporary basis risk arising from the execution of its Libor transition programme should be allowed for within its model.

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[27] Rule 10.3 in the Solvency Capital Requirements Part of the PRA Rulebook.
[28] Rule 3.3(1) in the General Provisions part and Rule 11.6 in the Internal Models part of the PRA Rulebook.

Appendices

1	**Statement of Policy 'The PRA's approach to the publication of Solvency II technical information', available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/the-pras-approach-to-publication-of-sii-technical-information.**
2	**June 2021 'deep, liquid and transparent' assessment of the SONIA OIS market, available at: https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/solvency-ii/technical-information.**