

Supervisory Statement | SS6/16

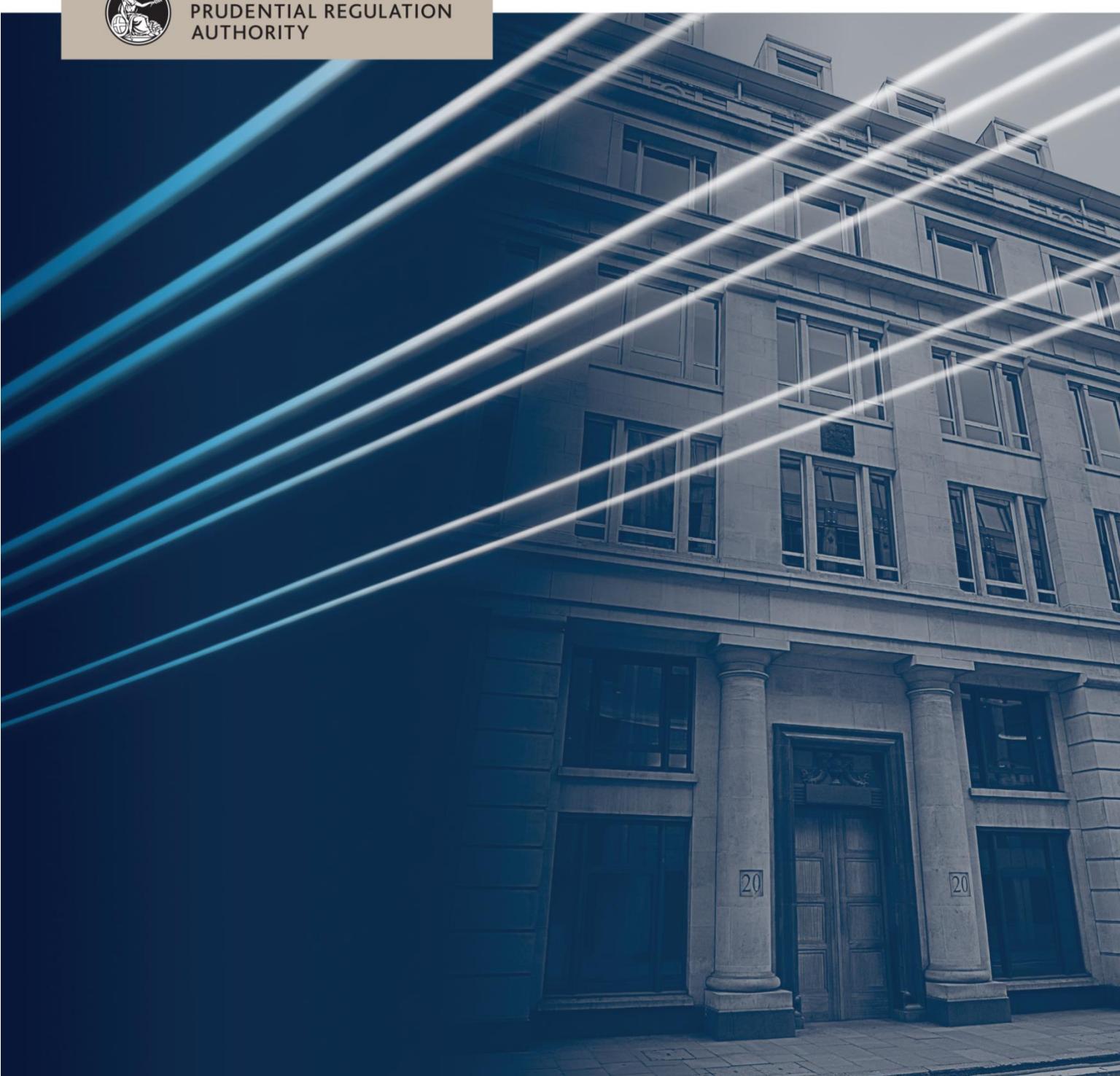
Maintenance of the ‘transitional measure on technical provisions’ under Solvency II

April 2017

(Updating May 2016)



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1 Introduction

1.1 The Solvency II Directive allows for a recalculation of the transitional measure on technical provisions (TMTP)¹ every 24 months, or more frequently where the risk profile of the firm has materially changed. These Directive provisions have been transposed by HM Treasury’s Solvency 2 Regulations 2015 (2015/575) (see Regulation 54).² The purpose of this supervisory statement is to provide clarity with respect to the PRA’s expectations as to how the TMTP should be maintained over the transitional period and the process for recalculations of the TMTP. It should be read alongside Regulation 54 of the Solvency 2 Regulations 2015, the Transitional Measures Part of the PRA Rulebook and the Supervisory Statement 17/15 ‘Solvency II: transitional measures on risk-free interest rates and technical provisions’.³⁴

1.2 This statement is of interest 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 that have been considering applying to use this transitional measure.

1.3 In particular, this statement sets out the PRA’s expectations and proposed process for:

- how the calculation of the amount of the TMTP should be maintained over the transitional period;
- requesting that a firm carry out a recalculation of the transitional measure; and
- assessing a firm’s application for a recalculation on the basis of a material change in risk profile.

1.4 This statement expands on the PRA’s general approach as set out in its insurance approach document.⁵ By clearly and consistently communicating its expectations of firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates, and contributing to securing an appropriate degree of protection for policyholders. The PRA has considered matters to which it is required to have regard, and it considers that this statement is compatible with the regulatory principles and relevant provisions of the Legislative and Regulatory Reform Act 2006. This statement is not expected to have any direct or indirect discriminatory impact under existing UK law.

1.5 This statement has been subject to public consultation⁶ and reflects the feedback that was received by the PRA.

2 Recalculations of the transitional measure

Paragraphs 2.1-2.18 of the original SS6/16 (May 2016) have been moved to a new Chapter 4, see below.⁷

¹ Previously referred to as the transitional deduction from technical provisions.

² March 2015: www.legislation.gov.uk/uksi/2015/575/pdfs/uksi_20150575_en.pdf.

³ November 2016: www.bankofengland.co.uk/pru/Pages/publications/ss/2016/ss1715update.aspx.

⁴ On 28 April 2017, this SS was updated – see annex for details.

⁵ ‘The Prudential Regulation Authority’s approach to insurance supervision’, March 2016: www.bankofengland.co.uk/publications/Pages/other/pru/supervisoryapproach.aspx.

⁶ PRA Consultation Paper CP15/16, ‘Recalculation of the ‘transitional measure on technical provisions’ under Solvency II’, April 2016: www.bankofengland.co.uk/pru/Pages/publications/cp/2016/cp1516.aspx, and PRA Consultation Paper CP47/16, ‘Maintenance of the ‘transitional measure on technical provisions’ under Solvency II’, December 2016: <http://www.bankofengland.co.uk/pru/Pages/publications/cp/2016/cp4716.aspx>.

⁷ This was updated on 28 April 2017 - see annex for details.

2A Components of the transitional measure

2A.1 The TMTP provides relief from the increase in technical provisions which results from changes introduced by Solvency II (in respect of business written before the introduction of the Solvency II regulatory regime), including the introduction of the risk margin. Where the TMTP makes a material contribution to own funds, the PRA expects firms to analyse the material components and drivers of this benefit to facilitate better risk management. The PRA expects that this analysis would be included within firms' own risk and solvency assessments, including how the components may change over time and under a range of operating conditions, and that firms will make this analysis available to the PRA.

3 Consistency of the Solvency I and Solvency II bases

3.1 Pillar 2 insurance liabilities are the starting point for the calculation of the TMTP. Firms are reminded that as set out in condition 1¹ the total amount of the TMTP applied to the Solvency II technical provisions may not exceed the maximum TMTP defined as the difference between Solvency II technical provisions and Solvency I Pillar 2 technical provisions (calculated in accordance with INSPRU 7²) with respect to the Homogenous Risk Groups (HRGs) to which TMTP will be applied. The PRA is aware that firms may inadvertently breach condition 1 through allowances being made for the changes in deferred tax liabilities. Firms are therefore reminded that the comparison required by condition 3³ (the financial resource requirement ('FRR') test) should be applied after allowing for the impacts of any change in deferred tax and its loss-absorbing capacity, but the application of any limit to the TMTP in order to meet condition 3 should not result in condition 1 ceasing to be met.

3.2 The underlying assumptions of both Solvency I Pillar 2 and Solvency II technical provisions are on a best estimate basis. Both Solvency II and the INSPRU 7 rules and guidance as at 31 December 2015 include provision for the best estimate basis to be based on up-to-date and credible information, and to reflect current operating experience. Firms are expected to review the best estimate assumptions and methodologies at regular intervals, and when it is appropriate, to make changes that reflect changes in operating experience and the firm's risk profile. The PRA previously communicated that in carrying out the initial TMTP calculation, the PRA expects firms to use consistent best estimate assumptions for both Solvency I Pillar 2 and Solvency II, which reflect the expected operating experience of the business.⁴

3.3 Where changes are made to best estimate assumptions which are inputs to both the Solvency I and Solvency II bases, and these changes have a material impact on the level of technical provisions, the PRA expects that the assumption changes should be made consistently within the Solvency I Pillar 2 (and Pillar 1 where the FRR test applies or is at risk of applying) and Solvency II best estimate bases. The PRA's view is that the impact of such an assumption change should not be included within the TMTP benefit as the change reflects changes in operating conditions or the firm's risk profile, rather than being introduced by Solvency II requirements themselves. The need to maintain consistency is an ongoing requirement, and applies both in the initial calculation of TMTP and in any subsequent recalculation.

3.4 It should not be assumed that maintaining consistency between Solvency I and Solvency II requires the equalisation of all assumptions. In particular, the review of a firm's Solvency I Individual Capital Assessment (ICA), and determination of Individual Capital Guidance (ICG), will have

¹ Condition 1 in table 3, Regulation 54 of the Solvency 2 Regulations 2015 (2015/575).

² Paragraph 10(b) of Regulation 54, Solvency 2 Regulations 2015 (2015/575), defines INSPRU 7 for the purposes of TMTP calculation.

³ Condition 3 in table 3, Regulation 54 of the Solvency 2 Regulations 2015 (2015/575).

⁴ Paragraphs 3.2 and 3.4 of PRA Supervisory Statement 17/15 'Solvency II: transitional measures on risk-free interest rates and technical provisions' UPDATE, November 2016: www.bankofengland.co.uk/pru/Pages/publications/ss/2016/ss1715update.aspx.

considered the aggregate strength of the valuation basis. Hence it may not be appropriate to equalise individual Solvency I assumptions to the equivalent assumptions made in the Solvency II valuation basis without assessing the impact on the aggregate ICA valuation. Firms should document how changes to the Solvency II best estimate basis have been reflected in the Solvency I basis(es) and make this available to the PRA upon request.

3.5 The PRA has previously given guidance¹ that it does not generally expect to revisit or reassess ICG as part of the process of approving a firm's application for TMTP relief, but that a firm may request, and the PRA will consider conducting, a proportionate review of ICG if it believes that the assumptions underlying its most recent ICA review and ICG are out-of-date and that this is having a material impact on the TMTP. For example, where the PRA's view and understanding of the risks that a firm is exposed to has changed, or following a Part VII transfer, it may be necessary to consider the appropriateness of a firm's ICA basis. The PRA will also consider initiating a proportionate review of a firm's ICG if the PRA believes that the ICA basis has not been maintained consistently with the Solvency II basis and may be resulting in an inappropriate calculation of TMTP.

4 Recalculations of the transitional measure

Recalculation at 24-month intervals

4.1 The Solvency II Directive allows for a recalculation of the transitional measure every 24 months without further conditions either on request by a firm or on the initiative of the supervisory authority. The PRA expects firms to carry out this recalculation at the end of every 24 months following the commencement of the transitional measure on 1 January 2016. Firms will be expected to update the calculation of this measure as at the last working day of the years 2017, 2019, 2021, etc. This will help to promote a continuing alignment between the relief afforded by the TMTP and those elements of the technical provisions for which it was designed.

Recalculation at an earlier date arising from a material change in risk profile

4.2 The PRA may request that a firm carry out a recalculation of the transitional measure at any time if the firm's risk profile has materially changed since the approval was initially granted (or since the last time a recalculation was approved). Solvency II also makes provision for a firm itself to apply for approval to carry out a recalculation in similar circumstances. Should a firm wish to make use of this provision, it will need to present sufficient evidence to the PRA of a material change in risk profile.

Circumstances giving rise to recalculation because of a material change in risk profile

4.3 In the PRA's view a variety of circumstances may give rise to a material change in risk profile. Risk profile changes that may trigger a recalculation include but are not limited to the following examples:

- acquisition or disposal of business priced and written before 1 January 2016;
- material changes to the reinsurance programme for business priced and written before 1 January 2016;²
- unexpected changes to the run-off pattern of the insurance obligations in scope of the transitional measure;

¹ Paragraph 3.18 of PRA Supervisory Statement 17/15 'Solvency II: transitional measures on risk-free interest rates and technical provisions' UPDATE, November 2016: www.bankofengland.co.uk/pru/Pages/publications/ss/2016/ss1715update.aspx.

² Reinsurance will be considered on a case-by-case basis. Further details on the PRA's expectations in relation to reinsured business are set out in SS17/15, see footnote 1.

- a change in the firm's use of either the matching adjustment or the volatility adjustment; or
- changes in operating conditions, including in interest rates or market prices of other financial assets leading to revised market risk exposures, or crystallisation of an insurance risk exposure, eg a change in projected mortality experience.

4.4 The points set out in paragraph 4.3 are only examples and the PRA would consider the need for a recalculation on a case-by-case basis.

4.5 Where a firm has knowledge of an upcoming transaction or other circumstance which will likely give rise to a 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 (such as in operating conditions) which could not have been anticipated, eg a significant change in interest rates or crystallisation of an insurance risk exposure, the PRA expects firms to apply for recalculation as soon as is feasible following the risk profile change. The PRA expects that this would not normally be more than three months after a material risk profile change occurs. Further, 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. A firm should contact its supervisor if it considers that circumstances exist which could justify a divergence from the above expectations.

4.6 The PRA intends to examine external market-wide events, such as significant changes in the risk-free rate published by the European Insurance and Occupational Pensions Authority (EIOPA), every six months to determine whether changes in market conditions are likely to have created a material change in firms' risk profiles. Firms may then be invited to make an application for a recalculation at that point. However, applications for a recalculation will still be assessed individually, on the basis of each firm's justification of how the market-wide event has caused a material change to its risk profile. The PRA will take into account the same factors, and in particular those set out in paragraph 4.10 below, in deciding whether to invite firms to make an application for a recalculation, and in making an assessment of a firm's justification of a material change in risk profile. The PRA's review of external market-wide events does not preclude firms from making an application at any point: it is intended to facilitate an efficient approval process at regular intervals.

4.7 The PRA expects firms to develop their own policy for recalculations of the transitional measure. This should set out, for example, the triggers for the firm to apply for a recalculation, which the PRA expects to be symmetrical, ie taking into account the event of an increase and a decrease in the transitional measure. The policy should also set out how the design and calibration of the triggers are related to the firm's risk profile.

4.8 When developing this policy, firms should also consider the other actions that would be triggered by a material change in risk profile. For example, a firm is likely to need to update its ORSA and, where necessary, its internal model to reflect this change.

4.9 The PRA notes that volatility in solvency coverage can arise from a number of sources, which include but are not restricted to those that would be offset by a TMTP recalculation. The PRA still expects firms to ensure that their asset-liability management policies are appropriate to manage solvency coverage within their stated risk appetite.

The PRA's assessment of a material change in risk profile

4.10 Where changes in operating conditions give rise to a potential change in risk profile the PRA will make an assessment of the materiality of that change, which will take into account all and any of the:

- (i) change in the risk-free rate since the date of the last recalculation;
- (ii) impact on a firm's solvency coverage ratio; and
- (iii) impact of a recalculation on a firm's solvency coverage ratio.

4.11 Where the change in risk profile potentially results from events other than changes in operating conditions, for example, as a result of the other circumstances set out in paragraph 4.3, then only (ii) and (iii) will be relevant.

4.12 The PRA expects that with respect to (i), a change of 50bps or more in the 10-year risk free rate is likely to be the point at which a material change could reasonably be expected to occur. In reaching this judgement, the PRA gave consideration to the historical distribution of six-monthly risk-free rate changes. It is the PRA's view that sustained changes in risk-free rates in excess of this threshold are likely to represent a material change to the current interest rate conditions. A sustained change is likely to be either a change that has persisted for a significant period of time or one that has been driven by factors that are likely to persist for a significant period of time. In reaching this judgement, the PRA considered evidence on interest rate conditions prevailing since 2009 but the PRA's approach would be reviewed should there be a material and sustained change in observed interest rate volatility.

4.13 The PRA has indicated that changes to risk-free rates will be particularly relevant as such changes are likely to result in variation in the risk margin. The risk margin is a key component of technical provisions that the TMTP is off-setting, and affects all firms. Severe and sustained moves in other market risk factors, such as changes in credit spreads, could also be relevant in considering the circumstances set out in paragraph 4.10. In such cases a firm may apply to the PRA for approval to recalculate its TMTP. However, a change in credit spreads is not likely to lead to a material change in risk profile for all firms as this will depend on the asset holdings of each firm.

4.14 For a change in risk profile to be considered as material, the PRA will consider whether there has been a material increase or decrease in a firm's solvency coverage ratio at the legal entity level. The degree of change that is considered material will depend on individual firms' risk profiles.

4.15 With respect to criterion (iii) of paragraph 4.10, the PRA would not generally expect firms to apply for a recalculation if the resulting increase or decrease in solvency coverage ratio at the legal entity level were less than 5 percentage points. If the resulting change were smaller than this, the PRA expects that firms would be unlikely to apply for a recalculation, given the other actions that this would likely trigger.

4.16 The PRA expects that firms will submit appropriate evidence of a material change in risk profile when applying to carry out a recalculation, taking into account the PRA's views on materiality set out in paragraph 4.10. For example, with regards to (ii) of paragraph 4.10, the PRA expects firms to explain the materiality of the change in a firm's solvency ratio by comparison with the expected frequency and likelihood of such a change occurring (ie in relation to the firm's probability distribution of changes in solvency ratios and changes in own funds, as such distributions vary between firms). It is the PRA's view that the expected frequency and likelihood of changes occurring in solvency ratios and own funds are key indicators in determining what constitutes a material change in risk profile.

Proportionate approach to carrying out a recalculation

4.17 The PRA will take a proportionate approach with respect to firms' recalculations of TMTPs. In particular, the PRA expects that the level of detail in a firm's calculation methodology will be proportionate and firms should discuss their proposed methodology with their supervisors. The FRR test will still apply and firms will be expected to demonstrate robust internal governance to support any conclusion that the test is still met.

4.18 The PRA recognises that a proportionate approach in the calculation of the TMTP may involve the use of estimates, for example those used for firms' solvency monitoring processes. The methodology used to calculate the TMTP, in particular where this relies on simplifying approximations, should be clearly documented. The use of less precise methodologies should not result in the material overstatement of the amount of TMTP claimed (ie condition 1 ceases to be met) and should not introduce material distortion into the evaluation of a firm's own funds and hence solvency position.

4.18 Firms will also need to differentiate between assets and liabilities applicable to business written before and after the introduction of Solvency II. The PRA expects only the former to be included in the TMTP. The PRA expects firms to take a pragmatic approach in identifying the components of the balance sheet which are within the scope of the TMTP calculation. In some cases it may be necessary to make assumptions as to how to do this, for example whether assets should be hypothecated between cohorts of the business written before and after the introduction of the Solvency II regime.

4.19 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. The PRA recognises, however, that it may be burdensome for a firm to determine the value of Solvency I financial resources requirements for business written after the introduction of Solvency II. In this case, a firm may, however, be able to use just the business written before the introduction of Solvency II as part of a proxy calculation, 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.

4.20 The PRA considers that when undertaking a recalculation, the Solvency II Directive does not explicitly require firms to reflect in the amount of the transitional deduction the actual run off of insurance liabilities since the last (re)calculation and the 1/16th linear deduction (ie a ‘double run-off’ effect). Firms should speak to their supervisors about this when discussing their proposed methodology for recalculations.

4.21 The PRA recognises that it may be burdensome for firms that have recalculated their transitional measure, as a result of a material change in risk profile, shortly before the end of a 24-month period to then be expected to carry out another regular recalculation, if the resulting change would be minimal. In such cases, the PRA is likely to take a proportionate approach and not expect the firm to carry out this recalculation. The PRA expects, however, that such a firm would only apply for a further recalculation before the last working day in December of the next 24-month period in the event of a material change in risk profile.

Amount of TMTP applied by a firm

4.22 The Solvency 2 Regulations 2015 (2015/575) prescribe the amount of the transitional deduction to be applied by a firm to be between zero and a maximum amount.¹ If a decision is taken by a firm to apply less than the maximum amount, the PRA expects the firm to include both the maximum amount and actual TMTP amount in the notes to market disclosures, and to share this information with its supervision team. The firm should maintain a transparent approach to determining the

¹ Condition 1 in table 3, Regulation 54 of the Solvency 2 Regulations 2015 (2015/575).

amount of TMTP benefit it is applying and the PRA expects this approach to be followed consistently by a firm within all Solvency II reporting including Quarterly Reporting Templates (QRTs) and to be reflected within a firm's ORSA and risk management framework.

4.23 The PRA expects that a firm's disclosure of its solvency ratio to the market will include an allowance for TMTP no 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 4.22 above.

Assessment by a firm's audit committee

4.24 The decision taken by the PRA in the event of a request for approval to recalculate TMTP will be a decision about whether condition 4¹ is met, ie whether or not the risk profile of the firm has changed materially. The audit committee should form a conclusion independently about whether or not the firm continues to meet the other conditions set out in Regulation 54 of the Solvency II Regulations 2015 (2015/575). The calculation to be performed will impact the technical provisions and therefore any simplification other than full recalculation of Solvency I and Solvency II figures at the date of the material risk profile change (for example the use of a different calculation date and rolling forwards) is expected to be assessed by the audit committee as to whether it complies with Article 56 of the Solvency II Commission Delegated Regulation 2015/35. Neither a firm nor its audit committee should take the PRA's approval of a recalculation as being acceptance of any methodology that has been proposed for that recalculation, other than any aspects explicitly agreed with their supervision teams. This responsibility for the audit committee also applies at the 24-month recalculation points.

¹ Condition 4 in Table 3, Regulation 54 of the Solvency 2 Regulations 2015 (2015/575).

Annex – SS6/16 updates

This annex outlines changes made to SS6/16 since its publication in May 2016.¹

April 2017

28 April

This SS was updated following publication of Policy Statement (PS) 11/17 ‘Maintenance of the ‘transitional measure on technical provisions’ under Solvency II’² specifically:

- the title of SS6/16, and paragraphs 1.1 and 1.3 have been updated to reflect the expanded scope of the SS;
- a new Chapter 2A has been included that sets out the PRA’s expectations that firms should analyse the material components and drivers of TMTP relief;
- a new Chapter 3 has been included setting out the PRA’s expectations on how firms should keep Solvency I and Solvency II valuation bases consistent; and
- Chapter 4 contains the original 2.1 to 2.18 and additional text added to clarify the PRA’s expectations with respect to the:
 - (i) timeliness of a firm’s application for recalculation;
 - (ii) use of approximate methodologies in calculating the amount of TMTP relief;
 - (iii) application of the financial resources requirement (FRR) test to business written after the introduction of Solvency II; and
 - (iv) amount of TMTP benefit to be applied by a firm.

¹ www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss616.aspx.

² April 2017: www.bankofengland.co.uk/pra/Pages/publications/ps/2017/ps1117.aspx.