

Supervisory Statement | SS23/15

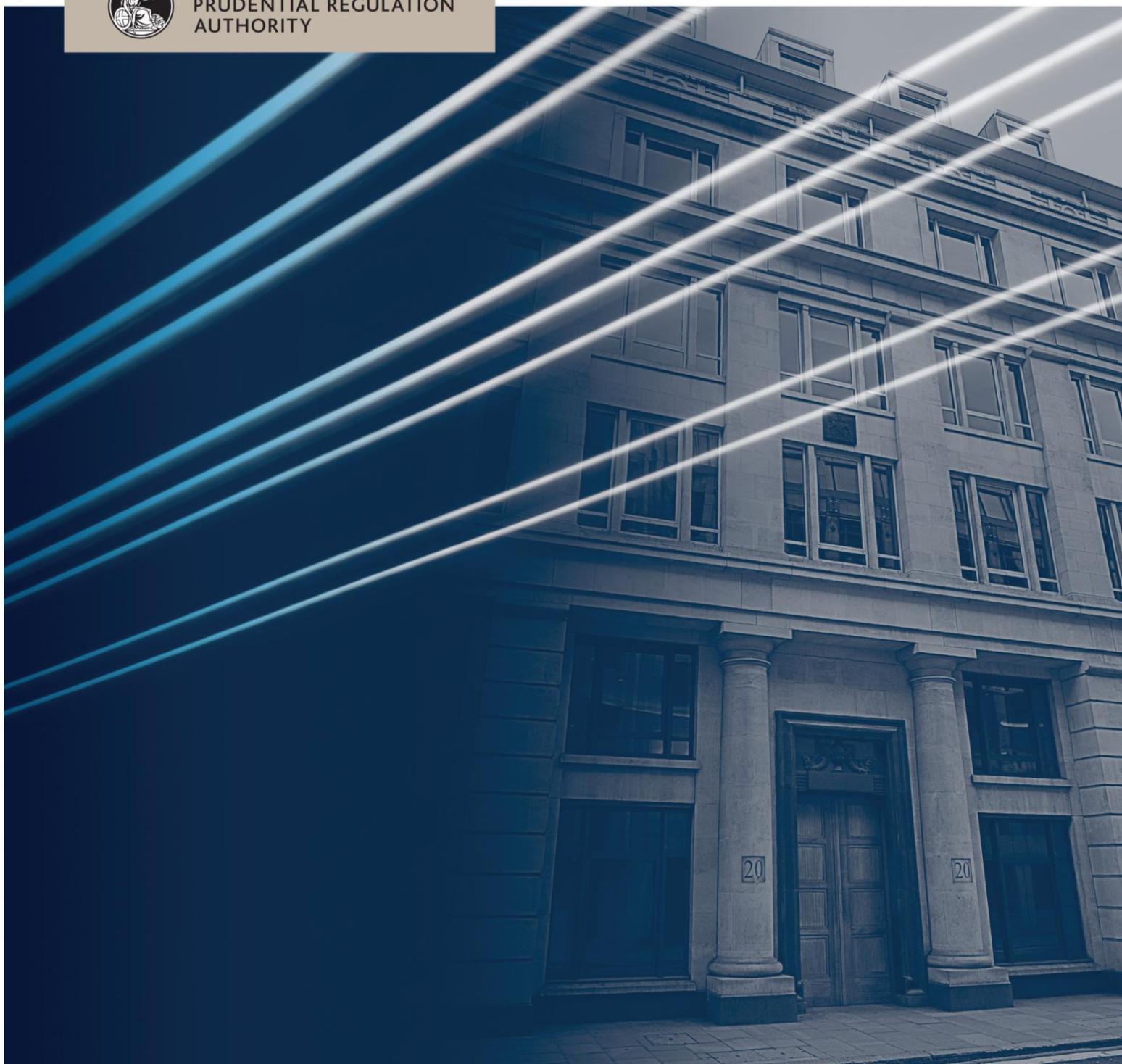
Solvency II: Supervisory approval for the volatility adjustment

October 2018

(Updating June 2015)



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AUTHORITY





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1 Introduction

1.1 This supervisory statement is addressed to UK Solvency II firms and to Lloyd's. It sets out the Prudential Regulation Authority's (PRA's) expectations of firms applying for permission to apply a volatility adjustment (VA), in accordance with Regulation 43 of the Solvency II Statutory Instrument.¹

1.2 In particular, this statement clarifies:

- the items that should be included in an application to use the VA;
- how the PRA will use the content of applications to assess whether the statutory conditions for approval to use the VA have been satisfied;
- the VA's intended purpose; and
- how the VA approval process will work; and its interaction with other Solvency II approval processes.

1.3 Firms should read this statement alongside the relevant European legislation, as well as relevant Parts of the PRA Rulebook and the Statutory Instrument.

1.4 This statement expands on the PRA's general approach as set out in its insurance approach document² and the Technical Provisions Part of the PRA Rulebook. By clearly and consistently explaining its expectations of firms in relation to approving the VA, 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.

1.5 The PRA believes that the benefits associated with this supervisory statement are proportionate to the costs. By providing firms with greater clarity regarding the approval process, the PRA seeks to ensure that firms have sufficient time to prepare applications and to meet regulatory requirements.

1.6 The PRA has also had regard to its secondary competition objective and considers that the content of this statement facilitates effective competition by providing all firms with a transparent framework regarding the application process.

1.7 This statement has been subject to public consultation and takes into account the feedback that was received by the PRA.³ The proposals in this statement are not expected to have any direct or indirect discriminatory impact under existing UK law.

¹ Financial Services and Markets (the Solvency 2 Regulations 2015) ('the Statutory Instrument') <http://www.legislation.gov.uk/ukxi/2015/575/contents/made>.

² 'The Prudential Regulation Authority's approach to insurance supervision', available at: <https://www.bankofengland.co.uk/news?NewsTypes=65d34b0d42784c6bb1dd302c1ed63653&Taxonomies=973f7bc68fd74abca30287f8a0a15fa3&Direction=Latest>.

³ CP11/15 'Solvency II: supervisory approval for the volatility adjustment', March 2015: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-supervisory-approval-for-the-volatility-adjustment>.

2 Content of the application

2.1 The PRA intends to operate an efficient and proportionate process for considering applications for permission to apply a VA. This supervisory statement seeks to minimise additional administrative burden on firms.

2.2 The PRA will need to be satisfied that the conditions set out in regulation 43(4) of the Statutory Instrument are met before granting permission to apply a VA. When compiling an application, firms should consider these conditions and ensure that the content they include in their applications is sufficient and adequate for the PRA to make this determination.

2.3 When considering the level of explanation, description or evidence to provide in their applications, firms should have regard to the principle of proportionality. The greater the impact of the VA on the firm's financial position and risk profile, the greater the expected level of detail and justification in the application. The PRA will adopt a proportionate approach when reviewing applications, consistent with its general supervisory approach.

2.4 Applications should include the following information, required under the Solvency II Directive ('the Directive'):

- the written policy on risk management required by Conditions Governing Business 2.4 of the PRA Rulebook, including:
 - o the firm's policy on the criteria for the application of the VA, in accordance with Conditions Governing Business 2.5(2) of the PRA Rulebook;
 - o the firm's assessment of: the sensitivity of the technical provisions and eligible own funds to the assumptions underlying the calculation of the VA; the possible effect of a forced sale of assets on the eligible own funds; and the impact of a reduction of the VA to zero in accordance with Conditions Governing Business 3.2(3) of the PRA Rulebook;
- as required by Conditions Governing Business 3.1(3), the liquidity plan projecting the incoming and outgoing cash flows in relation to the assets and liabilities subject to the VA;
- where the reduction of the VA to zero would result in non-compliance with the Solvency Capital Requirement (SCR), an analysis of the measures the firm could apply in such a situation to re-establish the level of eligible own funds covering the SCR or to reduce its risk profile to restore compliance with the SCR, in accordance with Conditions Governing Business 3.3;
- as required by Conditions Governing Business 3.8(4), the assessment of compliance with the capital requirements referred to in Conditions Governing Business 3.8(2)(b), with and without taking into account the VA;
- any information not listed above that the firm believes is relevant; and
- a cover letter stating that the application is endorsed by the senior manager who is responsible for the ORSA that is presented to the firm's governing body, and explaining how the conditions set out in Regulation 43(4) of the Statutory Instrument are met.

2A Intended purpose of the VA

2A1 The PRA expects firms to consider, before applying for approval to use the VA, whether the application is consistent with the intended purpose of the VA.

2A2 The purpose of the VA is to mitigate the effect of exaggerations of bond spreads in order to prevent pro-cyclical behaviour.⁴ The PRA considers that the VA achieves this by-preventing the requirement for market-consistent valuation of assets and liabilities under Solvency II from dis-incentivising insurers from investing in assets that it would otherwise be appropriate for the insurer to hold, taking into account the nature and duration of their insurance liabilities. The VA therefore aims to mitigate ‘artificial’ balance sheet volatility caused by short-term market volatility in the value of assets arising from the exaggerations of bond spreads by allowing insurers to reflect movements to those asset prices within the market-consistent valuation of the corresponding liabilities. The purpose of the VA is not to help smooth volatility generally in the Solvency II balance sheet arising from movements in the risk-free rate.

2A3 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.

2A4 For these reasons, firms are expected to satisfy themselves, and on request show the PRA how they have satisfied themselves, that the VA is applied in a manner that is consistent with its intended purpose.

3 Assessing satisfaction of the three statutory conditions

3.1 The Appendix below shows, at a high level, how firms could use their applications to demonstrate compliance with each of the three statutory conditions in Regulation 43(4) of the Statutory Instrument. The suggested content is not exhaustive, but instead aims to indicate what the PRA will look for when assessing whether the conditions for approval are met.

3.2 Supporting detail about the PRA’s assessment of each of the three statutory conditions is below.

Condition 1: the VA is correctly applied to the relevant risk-free interest rate term structure in order to calculate the best estimate

3.3 The PRA must be satisfied that the correct VA would be applied to the insurance obligations, taking into account their currency and country of sale.

3.4 To evidence this, firms should clearly describe the liabilities to which the VA is intended to apply, the currencies in which these obligations are denominated, and the countries in which they are sold. Firms should also confirm that they do not apply a matching adjustment to these obligations. These items should form part of a firm’s written policy on criteria for application of the VA.

⁴ Recital 32 of the Omnibus II Directive.

Condition 2: the firm does not breach a relevant requirement as a result or consequence of applying the VA

3.5 At no time should a firm's use of the VA result in the firm breaching other requirements of the Directive. Some of the prudential risks created by inappropriate use of the VA were highlighted by HM Treasury in its consultation document relating to the VA.⁵ In light of the risks that the VA may introduce, the PRA expects firms to consider their compliance with the risk management requirements under Conditions Governing Business 2.5 and 3.1–3.7, and the Prudent Person Principle (PPP) under Investments 2–5 of the PRA Rulebook, in particular.

3.6 Consistent with its intended purpose, the VA enables a firm to smooth the balance sheet impact of short-term volatility in financial markets. This smoothing relies on the underlying assumption that the volatility (and any resulting depression of asset prices) is temporary and that the firm can continue to meet claims as they fall due without resorting to selling assets at temporarily depressed prices.

3.7 Firms should show that this underlying assumption is appropriate given their risk profile. As part of this, firms should demonstrate that they have fully identified any liquidity risk (or other risks) that may be introduced through the use of the VA, and that they have the adequate understanding, risk mitigation techniques and financial resources to manage those risks.

3.8 A key factor is the liquidity of the liabilities to which the VA is applied. The claim characteristics and surrender terms of insurance products vary widely. The PRA expects firms to consider the liquidity of their liabilities as part of the policy on the criteria for applying the VA. In general, the liability cash flows to which VA is applied should be sufficiently predictable that the firm can demonstrably manage any resulting liquidity risk.

3.8A Products containing financial guarantees may pose particular risks where a VA is applied, such as the risk that the cost of providing the guarantee is inadequately provisioned for.

3.8B The PRA expects firms to be able to demonstrate, as part of their risk management framework, how they will identify, measure, manage, monitor and report all of the risks that are introduced by use of the VA. Where firms consider risk management actions regarding guarantees (eg hedging decisions), the PRA expects firms to use valuation bases which are appropriate for their business and risk profile, independently of whether the VA is used.

3.8C Firms should also ensure that the SCR calculation is appropriately updated to reflect the firm's use of the VA.

3.8D The Own Risk and Solvency Assessment (ORSA) must include an assessment of the significance with which the risk profile of the firm deviates from the assumptions underlying the SCR.⁶ This assessment should be updated once the VA has been incorporated into the SCR calculation.

3.8E The ORSA must also include the firm's overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the firm,⁷ which should include risks that are not adequately captured within the SCR. For example, Solvency Capital Requirement – General Provisions 3.6 prevents insurers from reflecting the risk of loss

5 <https://www.gov.uk/government/consultations/solvency-ii-resolving-the-remaining-policy-issues-for-uk-transposition/solvency-ii-resolving-the-remaining-policy-issues-for-uk-transposition>.

6 Rule 3.8(2)(c) of the Conditions Governing Business Part of the PRA Rulebook.

7 Rule 3.8(2)(a) of the Conditions Governing Business Part of the PRA Rulebook.

of basic own funds resulting from changes to the VA in the SCR but where firms are materially exposed to this risk it should be included within the ORSA.

3.9 The Prudent Person Principle (PPP) requires that assets held to cover technical provisions are invested in a manner appropriate to the nature and duration of the liabilities. Firms should demonstrate that they have considered the compatibility of their investment strategy with the PPP, given that the VA is used. This consideration should encompass how closely the asset and liability cash flows are matched, and whether the firm is able to meet its obligations as they fall due, including under stressed conditions. It should also 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. Firms reliant on the yield from assets with an uncertain return, or on the yield from assets they intend to purchase at a future date, should consider the risk that the assumed return is not achievable in practice and demonstrate how this risk will be monitored and managed.

Condition 3: the application of the VA does not create an incentive for the undertaking to engage in pro-cyclical investment behaviour

3.10 The PRA must be satisfied that a firm's use of the VA will not result in pro-cyclical investment behaviour. In this context, pro-cyclical behaviour can be described as a firm increasing the risk profile of asset portfolios (by buying risky assets) during stable or upturn periods, and then derisking those asset portfolios (by selling those risky assets) during unstable or downturn periods.

3.11 To demonstrate that this condition is satisfied, firms should describe the interaction between the investment policy and the use of the VA. Where a firm holds an asset that it would reasonably expect to sell to meet outgo during a stressed or downturn period, the firm should be able to show that its decision to hold that asset is independent of its decisions to use the VA. Conversely, if use of the VA is a material driver for a firm to invest in a given asset, the firm should demonstrate that it expects to be able to hold that asset throughout any period of market stress.

3.12 The liquidity plan, and the demonstration of the effect of forced sales of assets on the firm's own funds, will also help the PRA to determine whether the firm's proposed use of the VA will support the underlying policy intent of reducing pro-cyclical behaviour.

4 The approval process

4.1 The PRA asks firms to notify their usual supervisory contacts at the earliest opportunity if they intend to make an application.

4.2 The PRA will determine all applications for VA approval within a period of 6 months from the date that a complete application is received. Having regard to its desire to run an efficient and effective approval process, the PRA will endeavour to make decisions within a shorter timeframe than this where possible. In particular, for applications to use the VA that are not dependent on other approval decisions such as internal model applications, the PRA will endeavour to make decisions within 6 weeks from receipt of a complete application.

4.3 In accordance with Regulation 55(1) of the Statutory Instrument, the PRA will issue firms with a written notice communicating the outcome of the application.

4.4 Firms are encouraged to include a completed checklist with their applications, as provided separately on the Bank of England website. While use of the checklist is not mandatory, it will help to ensure that firms have submitted the necessary information for the PRA to consider the application and avoid delays that may result from incomplete applications.

Interaction with other Solvency II approvals and contingency planning

4.5 The PRA recognises that there may be dependencies between a firm's Solvency II approval applications. For example, a firm may wish to use the matching adjustment (MA) for some of its business, but to use the VA as a contingency option for those parts of that business, if any, where the MA application is rejected. In this case, the PRA will consider MA and VA applications in parallel, if requested to do so by a firm.

4.6 Where a parallel review is requested, firms must make clear in their applications which is the preferred measure, and which is the alternative measure in the event that the preferred measure is not approved. A complete application must be submitted for each of the measures. If undertaking a parallel review, the PRA will endeavour to schedule its review work and decision panels so as to reach a 'joint decision' on the two approvals concurrently and communicate this simultaneously.

4.7 When submitting an application for the VA, firms should inform the PRA of any other approvals for which they have applied. The PRA also encourages firms to also give details of any other approvals for which they intend to apply during the next 12 months.

Appendix

Indicative mapping of application content to statutory conditions

Solvency II Directive Reference	Item in application	Statutory Conditions for supervisory approval of VA		
		VA is correctly applied	Use of VA is consistent with other relevant requirements	VA does not create an incentive for pro-cyclical investment behaviour
41(3)	Policy on the criteria for the application of the VA.	Description of obligations to which the VA will be applied, including currency and country of sale. Confirmation that the MA is not applied to the same obligations.	Description of how assets held by the firm are invested consistently with the Prudent Person Principle, given that the firm applies the VA. Evidence that liability features, eg surrender terms, are taken into account when deciding whether to apply the VA.	Description of the link between investment policy and use of the VA.
44(2a)	Sensitivity of technical provisions and eligible own funds to underlying assumptions.	Sensitivity analysis demonstrating that the firm understands the key drivers that would cause the VA to move and the resultant effect on technical provisions and own funds.		
44(2a)	Possible effect of forced sales of assets on own funds.			Demonstration that the possible forced sale of assets under stressed conditions would not have a material effect on the level of own funds.
44(2a)	Impact of a reduction of the VA to zero.	Quantitative illustration of effect of the VA on the firm's financial position, including technical provisions, own funds, and capital requirements.		Qualitative description of further impacts/actions the firm would take if the VA reduced to zero.
44(2)	Liquidity plan projecting the incoming and outgoing cash flows relating to assets and liabilities subject to VA.		Demonstration that the firm has adequate understanding, risk mitigation and financial resources to manage the liquidity risk on the business to which the VA is applied.	Demonstration that firm has sufficient liquidity to meet claims on an ongoing basis during stressed periods without resorting to selling illiquid assets.
44(2a)	Remedial actions if reduction of VA to zero results in SCR Breach.			Demonstration that loss of the VA would not lead to pro-cyclical derisking activity.
45(2a)	Own Risk and Solvency Assessment (ORSA) extract: Assessment of compliance with capital requirements, with and without VA.		Demonstration that the VA is adequately reflected in the ORSA.	

Annex – SS23/15 updates

This annex details changes made to SS23/15 following its initial publication in June 2015 following Consultation Paper 11/15.⁸

17 October 2018

Following publication of Policy Statement 22/18,⁹ SS23/15 was updated to:

- Update to the final bullet in paragraph 2.4 that the application should include a cover letter stating that the application is endorsed by the senior manager who is responsible for the ORSA that is presented to the firm’s governing body, and explaining how the conditions set out in Regulation 43(4) of the Statutory Instrument are met.
- A new chapter (2A) ‘Intended purpose of the VA’.
- New paragraphs 3.8A and 3.8E to clarify the PRA’s expectations for firms valuing and managing risks associated with financial guarantees.
- An addition to paragraph 3.9 to clarify the PRA’s expectations of firms when demonstrating whether the VA can be earned in practice.
- Include minor drafting changes to paragraphs 1.2, 3.5 and 3.7.
- Include a table of contents and make minor amendments to formatting to assist the reader, eg updating the hyperlinks in footnotes.

8 ‘Solvency II: supervisory approval for the volatility adjustment’, March 2015: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-supervisory-approval-for-the-volatility-adjustment>.

9 ‘Solvency II: supervisory approval for the volatility adjustment’, October 2018: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-supervisory-approval-for-the-volatility-adjustment>.