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| **Institute and Faculty of Actuaries**  **TMTP recalculation working party**  PRA TMTP simplification project | |
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**Purpose of this paper**

PRA has requested input from both the ABI TMTP working group and the IFoA TMTP working party to develop a simplified method of recalculating the TMTP.

The purpose of this paper is to collect together the IFoA TMTP working party views into a single document for input into the PRA TMTP simplification project.

# About the IFoA working party on TMTP recalculation

Solvency II came into force on 1st January 2016 and included a transitional measure on technical provisions (“TMTP”) designed to help smooth in the capital impact over a 16 year period. The working party’s view is that the main intention of the TMTP is to mitigate the impact of the introduction of the risk margin, which significantly increases the technical provisions of firms, relative to their Solvency I Pillar II liabilities.

In the lead up to Solvency II many were thinking of the TMTP as a fixed amount, set at the 1st January 2016, which would very simply run-off linearly over 16 years. Not much thought had been given to the potential need to recalculate and certainly not to the need to do so, so quickly after switching to the new regime. The market conditions experienced in the first half of 2016 significantly changed this view, so much so that TMTP recalculation have become a regular occurrence and one of the biggest challenges for many UK firms.

The majority of firms who hold a TMTP have now had at least two recalculations approved by the PRA; including the mandatory biennial recalculation as at 31st December 2017. Despite this large number of approved recalculations, there remains significant uncertainty in the industry around the approach and triggers for recalculation.

During 2016 the IFoA Life Board established a working party to provide timely input on the topical issue of TMTP recalculation. The focus of this working party is to:

* Understand the challenges associated with the recalculation of the TMTP,
* Identify what options are available to firms and the regulator to address these challenges, and
* Set out what good practice looks like.

The main outputs of the working party are:

* A presentation at the 2016 Life Conference, presented on the 4th November 2016.
* A detailed paper which expands upon the issues outlined in the Life 2016 conference presentation in more detail. This paper was published on the IFoA website on the 7th August 2017.
* A survey which aims to better understand how TMTP is calculated across the industry and which is expected in 2018.

**PRA TMTP Simplification Project**

The PRA has issued a note to the ABI TMTP Working Group and the IFoA TMTP working party to outline what they hope to achieve in the space of simplification of the TMTP. It has been prepared to explain the PRA’s aims, principles, ideas and planned process. This note is included in appendix A.

**Executive Summary**

The PRA has initiated a TMTP simplification project with the aim of reducing the burden on insurance companies from TMTP recalculation. The PRA has asked the IFoA and the ABI to contribute to this project.

The IFoA TMTP recalculation working party (“working party”) welcomes the opportunity to be involved in this project. However, the working party notes the scale of the challenge of creating a single formula (or formulae) that could be uniformly applied across the industry and consider this unlikely and difficult to achieve in practice. Instead, the working party suggests that the PRA could publish a list of simplifications that the PRA considers acceptable. Firms would then be able to use as many of these simplifications, subject to these leading to a reasonably accurate approximation.

It is also noted that the project’s scope should also consider whether to simplify complex TMTP regulations and their interpretation in the United Kingdom. Issues which arise from complex rules are perhaps better addressed through a simplification of these rules, rather than through innovative solutions.

At this stage of the project it would be wise to evaluate the objectives of the project and agree across the PRA, ABI and IFoA working party what would be regarded as a success. Once this has been agreed the IFoA working party aims to work closely with the ABI working group and the PRA on the next stages of the project, which is likely to include the refinement of potential solutions outlined in the ABI working group paper.

The working party regards the following to be the most important outcomes and measures of success of the TMTP simplification project:

* Firms may choose to adopt one of the published simplifications, but equally may continue to employ their current TMTP recalculation methodology, including any use of suitable approximations;
* The published simplifications should ideally be expressed in terms of the sources of TMTP, building on the analysis in the working party paper;
* The inputs of any published simplifications should be those key drivers of the change in TMTP value, the most material being interest rates;
* The published simplifications would only be considered a success if some, but not necessarily all, insurers were to adopt the emerging approach as soon as practically possible, or over the medium term. Given the involvement of the ABI, it should be possible to understand the likely “take up rate” before significant time and resources are expended on detailed solutions that will not be sufficiently adopted.
* One of the main practical challenges in recalculating Financial Resource Requirements is the unintended consequences of management actions, rather than mis-estimation of the impact of economic conditions. For example implementing a strategy to hedge market risks arising on unit linked business is likely to reduce the Solvency I Pillar II and Solvency II financial resource requirement (FRR), but could increase the Solvency I Pillar I FRR, and for some firms this would reduce the TMTP. Any approach developed should address this issue.

The working party have set out our view of the key practical challenges and our views on how these should be dealt with in section 3, including specific ideas on the structure of potential simplifications.

In addition to addressing the proposal set out by the PRA on how the TMTP is recalculated, the working party also believe that issues concerning the approval process for TMTP recalculation should not be forgotten about. As noted in our working party paper, TMTP recalculation requires an application to be submitted to, and approved by, the PRA, and the working party believe that this approach is inefficient. The working party believe that TMTP recalculation should operate based on principles agreed upfront, with the outworkings of these principles resulting in a TMTP which changes in a dynamic way.

1. **Aims of the TMTP simplification project**

The PRA note outlines the aim of the TMTP simplification project as follows.

*“The aim is to find a way of calculating TMTP, for its remaining lifetime of 14 years, which does not require insurance companies to maintain full processes and systems for 3 different valuation bases during that period.”*

There are various ways in which this aim could be achieved. At one end of the spectrum, the PRA could produce a simplified formula for calculating TMTP. Alternatively, firms could be left free to develop their own simplifications (with the PRA then deciding whether or not to approve the use of these simplifications). The PRA could perhaps publish a “tool kit” of simplifications which it believes to be acceptable: firms could then use as many of these simplifications as are appropriate for their particular circumstances.

The working party believe in practice it is unlikely that a single formula for recalculation would satisfy all firms. Not withstanding the nature of the formula(s) which are developed as part of the TMTP simplification project, the project should also seek to understand:

* The likelihood of the adoption of such formula(s) by firms given their adoption is not mandatory.
* In particular where firms have chosen to maintain or ‘sunk cost’ into existing recalculation methods, there may be hesitance to adopt a new TMTP recalculation method.
* Therefore an approach should be mindful of the need not to be so generic that it does not result in any firm adopting it.

Overall this project should gauge the opinions of firms on which of the proposed published simplifications are likely to be adopted prior to investing excessive time and resources on developing any specific published simplifications.

The project should use this information to understand what the project success criteria are. It may view the following as part of this:

* An adoption of published simplifications by a significant number of firms in full, or in part, for the first TMTP recalculation following the implementation day of this approach;
* Or the likely adoption by a significant number of firms in the future;
* Demonstrating the desire of the parties involved to work collaboratively on an industry wide issue.

1. **Principles of the TMTP simplification project**

The TMTP working party believes the following should be principles of the TMTP simplification project.

* 1. ‘Internal’ approach vs using a published simplification

This principle aligns to the second principle in the PRA TMTP simplification project note.

The working party believe the most important principle of the TMTP simplification project is that firms should be able to maintain an ‘internal’ approach to TMTP recalculation or can elect to follow a published simplification. In particular a firm may view the costs and benefits associated with an ‘internal’ approach outweigh the costs and benefits of adopting a published simplification

Though it is noted a firm may choose to transfer from their ‘internal’ method a published simplification as the materiality of the TMTP reduces over time.

* 1. TMTP recalculation method should not require firms to maintain full legacy systems

This principle aligns to the first principle in the PRA TMTP simplification project note.

This aligns to the overall aim of the TMTP simplification project, although the working party view this ‘principle’ as being the outcome of the TMTP simplification project i.e. it results in an approach that is sufficiently simplified, sufficiently widely adopted and uses reasonable approximations.

* 1. Reasonableness of approximations

This principle aligns to the fourth principle in the PRA TMTP simplification project note.

The reasonableness of any approximations should consider the following aspects.

Changes in market conditions

The reasonableness of any approximations to changes in market conditions such as movements in interest rates, equity markets, credit spreads etc.

Impact of ALM activity

The published simplifications should consider whether to take into account the impact of ALM activity. For example:

* Where a firm chooses to optimise the portfolio spread on assets backing annuity liabilities, for example through investing in more illiquid assets, the published simplification should consider whether to take into account potentially differing outcomes under Solvency II, Solvency I Pillar I and Solvency II Pillar II, or not.
* Where a firm implements a hedging programme to hedge exposure to market risk, for example using forward contracts or put options to hedge equity risk, the published simplifications should consider whether this is allowed for, and if so how.
* If the firm has chosen to hedge the risk margin interest rate exposure not offset by a TMTP, then it would expect the published simplifications to reasonably hedge the risk margin covered by the TMTP, when compared to a less approximate recalculation method. In particular it should not introduce any material second order mismatches.

Impact of management actions or strategic changes

The published simplifications should consider whether, or not, to take into the impact of management actions or strategic changes.

The practical experience of working party members is that the impact of management actions or strategic changes to the business are those that often have unexpected TMTP impacts which are often difficult to foresee in advance. For example the adoption of reasonable and generally accepted risk mitigation techniques could result in an offsetting reduction in TMTP. More specifically a strategy to hedge market risks arising on unit linked business is likely to reduce the Solvency I Pillar II and Solvency II financial resource requirement (FRR), but could increase the Solvency I Pillar I FRR, and for some firms this would reduce the TMTP.

Furthermore, and more abstractly, the approach to management actions not likely or permitted to be undertaken under the Solvency I regime should be considered. For example the shorting of shareholder units was not permitted under Solvency I, but is implemented by a number of firms following the implementation of Solvency II.

PartVII Transfers

As noted by the PRA, the approach should be allowed to be combined or disaggregated following a Part VII transfer of business from one insurance entity to another.

The use of a published simplification needs to be sufficiently well endorsed so that Part VII transfer independent expert can be confident in their use. Especially in the scenario where one block of business uses a different TMTP recalculation approach to the other block(s) of business and alignment is proposed following the Part VII transfer.

In addition the published simplifications would need to apply in the situation where the two blocks of business in scope of the Part VII have TMTP on difference bases. For example the TMTP for one block of business may be determined on the unrestricted basis, and the TMTP for the other block of business may be determined by reference to being restricted by the Solvency I Pillar I Financial Resource Requirement.

Changes in assumptions, methodology or calibrations

The published simplifications should consider whether or not to take into account the impact of changes in assumptions and methodology including internal model calibration changes. For example, the impact of changes in best estimate assumptions should be considered and allowed for consistently across all bases, including allowance for Solvency I Pillar I prudence.

The working party consider this most relevant to the Solvency I Pillar I Financial Resource Requirement and the Solvency I Pillar II capital requirements given the requirement for best estimate assumptions for Solvency I Pillar II and Solvency II to be consistent, though not necessarily equalised.

* 1. Single methodology for simplification

This principle aligns to the third principle in the PRA TMTP simplification project note.

As noted above it is unlikely a single approach could be developed which would satisfy all firms. The project should consider striking the balance between the extremes of developing a formula so simplified no firm would adopt it, relative to developing a formula so complex that whilst it caters for all firms current recalculation methods, it is onerous to implement and unwieldy to understand.

The working party believes the PRA could perhaps publish a “tool kit” of simplifications which it believes to be acceptable: firms could then use as many of these simplifications as are appropriate for their particular circumstances.

* 1. Partial adoption of formula

This does not align to a principle in the PRA TMTP simplification project note.

The project should consider whether a firm could adopt some or all of the published simplifications. For example a firm may recalculate the Solvency I Pillar I FRR using a published simplification, but continue to recalculate the remaining parts of its TMTP using an ‘internal’ approach.

For example in a recent PRA, ABI working group and TMTP working party meeting it was suggested that a toolkit be developed which firms could use some or all of the proposed simplifications, The working party believes this is an interesting idea which should continue to be developed.

1. **Key practical challenges of the TMTP simplification method**

When developing a method for calculating the TMTP which is simplified and does not require an insurance company to maintain full processes and systems, a number of aspects need to be considered.

1. Is there any scope to remove or reduce requirements, which would make any solution simpler to implement?
2. How many published simplifications are required? Should there be one published simplification or one for each of the unrestricted TMTP, the Solvency II Pillar I Financial Resource Requirement (FRR) and the Solvency II Pillar I FRR?
3. What should the structure and functional form of the proposed published simplifications be?
4. What should the inputs into the published simplifications be?
5. Are these inputs entirely derived in advance or should they be monitored and change over time?
6. What do transformations in company structure or management actions do to the published simplifications?
7. What incentives are there for firms to adopt these published simplifications?
8. Who is responsible for the adoption of a published simplification or otherwise?
9. What confidence or quality assurance can be provided to inform a company and its audit committee to convince it to adopt a published simplification?
10. How does a published simplification apply to a firm which wishes to maintain all or part of its current TMTP recalculation methodology?
11. How can a firm communicate the outcome of using a published simplification method both internally and externally?

Each of these aspects are expanded upon below.

1. **Is there any scope to remove or reduce requirements, which would make any solution simpler to implement?**

Removing the need to derive any aspect of the TMTP would make the development and implementation of any simplification solution more straight forward.

Example of aspects of the TMTP, which could be simplified, are:

* Removing the need for firms to recalculate Solvency II Pillar I, especially where this does not impact the level of the TMTP;
* Removing the need for firms to recalculate either Solvency II Pillar I or Solvency I Pillar II, where the TMTP is restricted by the FRR test and one of these Pillar is clearly the more onerous;
* Removing the need to derive the FRR test where the TMTP is based on the unrestricted TMTP and the TMTP is clearly not likely to have a FRR restriction;
* Reducing or recognising simplified approaches to meet disclosure requirements which may not be critical to deriving the value of the TMTP. For example deriving the value of ‘Solvency II Day 1 technical provisions’ in the S.22.05 QRT is not critical to the TMTP – the differences in Solvency I and Solvency II technical provisions and FRRs are critical;
* The need to consider aspects of TMTP recalculation that are not critical to the value of the TMTP, but are required due to TMTP legislation. In particular these aspects draw attention away from more important issues. For example the need to adjust the TMTP formula to avoid ‘double run-off’ which both meets the requirements of the Solvency II regulation and ensures a sensible outcome for TMTP.

1. **How many published simplifications are required? Should there be one published simplification or one for each of the unrestricted TMTP, the Solvency II Pillar I Financial Resource Requirement (FRR) and the Solvency II Pillar I FRR?**

The working party believes it is reasonable to have separate published simplifications for each of the following aspects of the TMTP.

1. Unrestricted TMTP
2. Solvency I Pillar I FRR, where Peak I is the most onerous of the Solvency I Pillar I Peaks
3. Solvency I Pillar I FRR, where Peak II is the most onerous of the Solvency I Pillar I Peaks
4. Solvency I Pillar II FRR

Given the FRR test includes all business in a legal entity, and not just business prior to the implementation of Solvency II, the Solvency II FRR is deliberately omitted from the list above.

Whether all of these aspects are required to be recalculated for a given TMTP recalculation will depend on the TMTP basis of a firm i.e. whether a firm’s TMTP is on a unrestricted basis, is clearly restricted by one of the Solvency I FRRs or the Solvency I FRRs are close and/or both need reassessing. However, a key simplification noted above is to calculate only one Solvency I Pillar.

It is asserted that the calculation of the Solvency II FRR, prior to the inclusion of the TMTP, is derived as part of the reporting requirements of Solvency II, and does not require a formula. The Solvency II FRR including the TMTP, and allowing for any required restriction, would be an outcome of the formulae outlined above.

1. **What should the structure and functional form of the proposed formula(e) be?**

It is proposed that:

* The structure of the proposed formula should be modular, with a standardised functional form.
* Each module should represent a source of TMTP as outlined in the working party’s paper on TMTP recalculation.
* The inputs into each module would vary depending on what source of the TMTP is being calculated, see below for examples.
* Where a firm has an immaterial exposure to a particular source of the TMTP the relevant module is not required to be calculated and it contributes zero to the firm’s TMTP.

Further consideration is required as to:

* Whether to allow the optionality for firms to apply more accurate methods, where appropriate, in lieu of any or all of this proposed formula;
* Whether an alternative method or structure of formula to that outlined above should be adopted?

Unrestricted TMTP example

The following is a prescriptive example of the structure of a formula for unrestricted TMTP. This formula is similar in format to the one proposed by the PRA and ABI working group, with the key differences being the inclusion of additional terms to allow for all differences in the unrestricted TMTP identified by the working party in their published TMTP recalculation paper.

It is envisaged that similar formulas are considered for the Solvency I Pillar I FRR and the Solvency I Pillar II FRR.

It should be noted that the final standardised approach may choose to ignore some of these differences if they were deemed to be immaterial by firms.

For the calculation the unrestricted TMTP at time t could consist of the following modules

Unrestricted TMTP (at time t) =

TMTP risk margin (t) module +

TMTP contract boundaries (t) module +

TMTP Solvency II MA and Solvency I Pillar II LP (t) module +

TMTP Solvency II VA and Solvency I Pillar II LP (t) module +

TMTP Solvency II and Solvency I Pillar II other risk free rate difference (t) module +

TMTP differences in with-profits future planned enhancements (t) module +

TMTP differences in with-profits future shareholder transfer liabilities (t) module +

TMTP differences in expense assumptions (t) module

Noting:

* The calculation of the unrestricted TMTP only applies to business written prior to the introduction of Solvency II, so differs to the FRR test which applies to all business in an undertaking;
* The unrestricted TMTP may only apply to specific homogeneous risk groups, and so may differ in scope to the FRR test which applies to all business in an undertaking;
* The approach should allow firms to include bespoke components where these form part of its approved TMTP recalculation methodology.

The derivation of the TMTP risk margin (t) module could be expressed as a function of the following inputs:

TMTP risk margin at time t – 1

Expected run off of TMTP from t-1 to t

Change in interest rates from time t-1 to time t

Duration of the risk margin at time t-1

Changes in material assumption and calibrations over the period t-1 and t

However, a proportionate approach to determining the risk margin for business in-force at Solvency II go-live at time (t) will depend on the individual circumstances of the firm and so it is apparent that the deriving of such a formula, including ensuring it is sufficiently robust would require a significant amount of industry, PRA and IFoA working party effort. It should be considered whether this effort is proportionate to the benefits of a simplified TMTP calculation method and as such could be left to individual firms to propose how to recalculate the risk margin.

1. **What should the inputs into the published simplifications** **be?**

The inputs should be readily available and not overly onerous to derive. If the published simplification is simple, but the inputs onerous to derive this would be contrary to the overall aims of the TMTP simplification project.

The inputs should intuitively capture factors which change the value of the TMTP. For example key economic indicators like the level of interest rates or the level of credit spreads.

1. **Are these inputs entirely derived in advance or should they be monitored and change over time?**

Ideally the derivation of the inputs and structure of the published simplifications should be undertaken once and not continually recalculated. Continual recalibration of these inputs would be contrary to the overall aims of the TMTP simplification project.

1. **What do transformations in company structure or management actions do to the published simplifications or inputs into the** **published simplifications?**

If a company chooses to use a published simplification, and it changes it’s company structure, the published simplification and its inputs should be sufficiently flexible to be applied to the new company structure.

Continuing the TMTP risk margin (t) example above, consideration will be required as to whether a simple addition (or separate) of the TMTP risk margin at time (t-1) is required, or whether additional allowance is required for changes in risk profile that may change diversification benefits.

1. **What incentives are there for firms to adopt these published simplifications?**

The most obvious incentive for firms is to apply a published simplification and decommission legacy processes and systems not required going forward. However a number of benefits from a simplified approach to TMTP recalculation may already have been realised by firms’ existing recalculation approaches.

However a business case would be required for firms to adopt a published simplification who have already invested time and money in developing their current TMTP recalculation methodology.

1. **Who is responsible for the adoption of a published simplification or otherwise?**

The PRA has indicated that the responsibility for ensuring the accuracy of the TMTP calculation is placed upon a firm, with a firm’s audit committee providing oversight of the calculation. It would logically follow that the decision as to whether to adopt a published simplification would fall upon the company, with the audit committee providing oversight of this.

1. **What confidence or quality assurance can be provided to a company and its audit committee to convince it to adopt a published simplification?**

Notwithstanding the point made in viii above, any industry wide or regulatory endorsement of the proposed published simplifications should help ease its implementation.

1. **How does a simplified method interact with a firm which wishes to maintain all or part of its current TMTP recalculation methodology?**

A firm may wish to adopt a ‘blended’ approach to calculating the TMTP i.e. using a published simplifications method for certain, potentially less material, aspects of recalculation, but use a more accurate, though approximate, method for other sources of TMTP. The approach taken would depend on the materiality of the firm, the complexity of the more accurate method, whether a firm is open or close to new business etc.

Consideration is required as to how to accommodate this, if at all.

1. **How can a firm communicate the outcome of using a published simplification internally and externally?**

Though not a new requirement, firms will need to articulate the impact of using (or not using) a published simplification both internally and externally. They should be able to explain the rationale for their choice, the upside and downside of choosing the published simplification over other options. For example the firm may trade capital resources for a more prudent, but easier to implement, published simplification.

**Appendix A – PRA TMTP Simplification Project Note (Issued by PRA on 10 January 2018)**

**PRA TMTP Simplification Project**

This note is intended to set out what the PRA hopes to achieve in the space of simplification of the TMTP. It has been prepared to explain our aims, principles, ideas and planned process to external parties, specifically the ABI and IFOA Working party.

**Aim**

The aim is to find a way of calculating TMTP, for its remaining lifetime of 14 years, which does not require insurance companies to maintain full processes and systems for 3 different valuation bases during that period.

**Principles**

We believe that the following principles should be followed

1. We aim to devise a TMTP recalculation method that does not require firms to maintain full legacy systems (Solvency I Pillar 1 and/or Solvency I Pillar 2), thereby allowing firms to use a simplified method after having completed the YE17 recalculation. Calculations involving Solvency II numbers as at recalculation dates on any or all of: the current policy portfolio; the historic portfolio as 31.12.15; or that element of the historic portfolio still in force at recalculation date; are acceptable. Specifically it is assumed that companies would be able to calculate the Risk Margin as at 31.12.15 on the basis applying at a recalculation date.

2. Under the terms of the Directive the PRA cannot compel firms to adopt a simplified TMTP calculation approach, or mandate any approach that would not allow a firm the option of a full calculation its INSPRU 7 liabilities. Therefore it would be up to companies to elect to use the simplification.

3. Ideally a single methodology for simplification should be developed. In particular a single method should make considerations regarding portfolio transfers between companies simpler. This may depend on what solutions can be developed but a single method is desirable.

4. Suitability should be assessed by each firm by considering whether or not the simplification results in a reasonably accurate approximation of what a fully recalculated figure would be both under normal conditions and under stress. This level of reasonableness would be assessed in terms of the base SCR of each company.

**Ideas**

5. We believe that we will need to examine both the base TMTP calculation method and the FRR test to achieve our aim.

6. Intercompany transactions will remain relatively common events, so any method may need to be able to apportion TMTP to any transferring block of business such that the TMTP benefit can be transferred with the business.

7. One possible simplification method (starter for discussion purposes), is that TMTP could be divided between a number of ‘buckets’. TMTP = [Risk Margint + Interest rate dependent factorst] + constantt + other variablet. Would the interest dependent factors be closely correlated to the Risk margin? Are the other variable small enough to split into one of the other buckets? If firms could provide an analysis of such an approach, it would be used to test the feasibility of a simplified approach and inform ‘stress testing’.

8. We do not wish to create another formal approval process but that some form of demonstration of accuracy within tolerance would be appropriate.

9. The current idea is that we would develop a set of scenarios and stress tests. Then Firms wanting to use the simplification method would produce a set of figures to demonstrate that under these the figure remains a reasonable approximation. These to be sent to PRA for agreement.

10. Firms should consider the risks arising from a simplified approach to calculating TMTP in their ORSAs, in particular the risk that the simplification results in a significantly higher TMTP than the maximum permitted.

11. The work on this is to proceed concurrently with work on Risk margin.

**Process**

The following process is envisaged

12. During January the PRA will develop proposals

13. Subject to Governance approval within PRA, a consultation to be issued in February/March

14. Companies and other interested parties invited to make submissions and normal process to follow.

15. Any policy statement, supervisory statement etc intended to be issued before end of year 2018

16. Any recalculations necessary before PRA issues policy statement to be done fully. After that companies can submit simplification proposals when recalculations are needed or beforehand, noting that PRA expects all firms to recalculate at next 2 year point (31/12/19).

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