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Recalculation of the ‘transitional measure on technical provisions’ under Solvency II - CP15/16

IFoA response to the Prudential Regulation Authority

13 May 2016

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Institute and Faculty of Actuaries

SII: CP15/16 Response
Romain Labaune
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

13 May 2016

Dear Romain,

IFoA response to CP15/16 SII: Transitional Measure on Technical Provisions

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Prudential Regulation Authority's (PRA) consultation paper on the transitional measure on technical provisions (TMTP), under Solvency II (SII). The IFoA's Life and General Insurance Boards have been involved in the drafting of this response. Some members of these boards have been actively engaged with the ongoing implementation of SII.

2. The TMTP is material to many insurers, and clarity on the future management and potential fluctuation in the TMTP is welcome. The consultation is important given the impact of market movements since 1 January 2016, which for many insurers has led to material increases in the risk margins.

3. We note the draft supervisory statement addresses both a mandatory recalculation at least every 24 months and considerable discussion of recalculation in other circumstances. We were unsure what purpose the mandatory recalculation was intended to achieve as no cost benefit analysis is given. So we believe it would be helpful for the PRA to expand on what it intends to do with the 24 month recalculation, to confirm it has no long-term intention here that might be disruptive to firms' business management. We note that some firms have already taken steps to hedge the SII balance sheet by adopting ALM strategies based on a fixed run-off of the Transitional Deduction (TD). The mandatory recalculation will require these firms to unwind such arrangements.

4. The other key part of the draft supervisory statement is, we believe, very helpful in setting out potential market-wide events which could give rise to a one-off recalculation. Section 2.6 talks of an 'increase and a decrease in the transitional measure' and thus implies that the PRA would countenance a revised calculation that leads to a TMTP higher than that approved at outset as at 1 January 2016.

Principles of one-off recalculation

5. The TMTP and its ability to be recalculated under changed market and other conditions can be a key part of insurers' risk management. Insurers therefore need certainty over this ability to recalculate and also to have timely procedures for the recalculation to take effect. We are concerned that paragraph 2.8 of the paper states: "Notwithstanding the use of recalculation in the event of a material change in risk profile, the PRA still expects firms to ensure that their

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asset-liability management policies are appropriate to manage the solvency coverage within their stated risk appetite.“ This seems to dilute firms' ability to rely on the recalculation, and it also seems to leave firms in an odd position where what they know will happen – that recalibration will occur if rates move materially – cannot be reflected in their hedging. The ability to report a TMTP consistent with the business structure and economic conditions at each reporting date will be helpful to both firms in managing their solvency position and regulators in avoiding 'lags' between the true risk profile and that effectively reported in the Quantitative Reporting Templates (QRTs), which may under- or over-state an insurer's solvency position unnecessarily.

6. As described above the TMTP recalculated, and subject to amendment, under a wide variety of scenarios may inhibit a firm's ability to transition and manage the business under SII rules. As already noted, firms may elect to manage their solvency position under SII, for example fully hedging the risk margin. Although this could lead to real interest rate risk and endanger profits, we believe the TMTP rules should give firms the flexibility to adopt such an approach, and should not discourage them from developing their risk management systems in line with SII.

Approval of TMTP changes

7. The consultation encourages firms to develop their own policy towards recalculation of the TMTP. We would strongly encourage this as providing clarity between both parties over the extent and circumstances to which a recalculation would be performed. Where a firm has developed such a policy and this has been accepted by the PRA there would be considerable advantage to allowing firms to perform the recalculation without prior approval and requiring only notification to the PRA of the recalculation at the time it is performed. An effective pre-agreed approval process will enable firms to incorporate the TMTP into their risk appetite and risk management system with confidence.

8. Paragraph 2.6 proposes that firms should define triggers which would cause them to apply for a recalculation of the TMTP. Rather than relying on firms to make such applications, we believe it would be preferable to operate a pre-approved process which enables automatic recalculation on reaching the specified triggers (or the 2 year reset), together with ad-hoc applications for changes in risk profile not amenable to triggers, such as reinsurance, transfers and disposals. Requiring separate applications in each case would imply a delay while these applications are considered for approval. This could easily be against a backdrop of steadily falling interest rates with a firm's solvency ratio coming under increasing pressure while it awaits PRA approval. We suggest this does not lend itself to stable risk/business management for the firm involved.

Practicalities for recalculation

9. The consultation did not cover either at a principles level or details level how the recalculation should be performed. Firms are naturally concerned that full recalculation of the ICA will be impractical for a wide variety of reasons. For some firms the reset would require Pillar 1 calculations to be performed, so it would be pragmatic to allow some approximations and simplifications. We believe that the costs to firms of having to calculate old methodologies would be significant, and they would increase over time as systems, risk profile and operating conditions increasingly change from those in existence at 1 January 2016. In addition, the relevance of the TD will diminish over time and there may be a point after which resets might cease.

10. We note that maintaining all the capabilities needed for a full recalculation is not a simple matter. While we accept firms must be able to recalculate we felt a mandatory recalculation was potentially onerous, particularly for smaller firms or mutual firms who may well have moved their accounts to a SII basis and thus reduced their capabilities to easily generate Solvency I, Pillar 1, results.

11. Whilst we support some flexibility for firms to choose appropriate methods for recalculating the TMTP, we believe the PRA should issue guidance in this area for consistent treatment across the industry. This should include setting out principles as to how the calculations should be performed that do not necessitate full recalculation. For example, where the risk margin is the material contributor to the TMTP firms may elect to recalculate this item alone rather than a full recalculation. Such a proportionate approach would considerably reduce the difficulties of maintaining at least two and potentially three Solvency bases.

12. We would welcome clarification from the PRA on whether, if the recalculation approach requires a firm to maintain old calculation bases and models, that firm would effectively need to carry out an external audit of more than one set of models. Also, if a change to a firm's internal model was approved and this affected the risk margin, would this automatically trigger a recalculation of the TMTP?

Recalculation of TMTP

13. We note that under some potential approaches to the recalculation firms may effectively suffer from 'double amortisation' depending how one interprets the drafting of the rules and the amortisation rate at recalculation. In particular, the PRA has acknowledged that the TD reset formula in Regulation 54 of the Solvency II Regulations 2015 is flawed and leads to this double amortisation. We would encourage the PRA to ensure that a recalculation of the TMTP neither improves nor reduces the benefit of TMTP purely from a recalculation and the impacts are directly linked to the updated risk profile.

14. We agree with the PRA view in 2.6 of the paper that triggers for recalculation should be symmetrical to ensure the TMTP is neither materially over- nor under-stated as a result of the changed risk profile.

PRA assessment of material change

15. As we note, the market movements since 1 January 2016 have only emphasised that the risk margin of SII is very sensitive to long term interest rates, particularly when rates are low. While the IFoA would encourage the PRA to seek improvements to the design of the risk margin, under the current design we support the ability to revisit the TMTP, since this helps to stabilise the risk margin.

16. Section 2.5 talks of the PRA looking at the changes in the EIOPA risk free curve every six months to determine whether external market wide events that constitute a material risk change have arisen. Subsequently firms are then required to apply for a recalculation. The speed at which markets can change and the significance of this on the exposures of the firm would not appear consistent with this process. Firms with material interest rate sensitivity would be expected to have robust monitoring and mitigation in place to cover such events. The IFoA does not believe such a monitoring system would give firms the speed and certainty over the recalculation that they need to ensure sound risk management. Again, recalculation in line with a firm's policy for the TMTP recalculation would be preferable for firms with

material exposures. The six month process outlined in section 2.5 may be more appropriate for smaller firms or those with less material interest rate sensitivities.

17. As noted above, instead of firms applying for a recalculation when triggers are reached, we support a pre-approved process which enables automatic recalculation on reaching the firm's specified triggers. One advantage of this would be clarity on the date of reset to be provided. It would be preferable to perform a reset on 31 December, if triggers reached during a preceding period applied on that day, rather than to do a reset on 28 October, say, just because the triggers were first reached on that day. In this way the trigger would not be applied if markets moved back to their previous position before 31 December.

18. Section 2.9 talks of considering changes in the ten-year risk-free rate since the date of the last recalculation (condition (i)). Since the sensitivity to risk free rates will vary by firm we would suggest that no single rate can be used to assess the materiality of a change in risk profile. We believe the focus should be on the materiality of the change in TD if it were to be reset. If the change in TD is not material then there seems little point in resetting it, regardless of what triggers have been reached. Conversely, if the potential change in TD on reset is material then the reset should be permitted regardless of the movement on trigger variables. We note that there are other drivers of TD reset, such as credit spread changes and lapse experience.

19. The PRA consultation outlines in section 2.9 three criteria used in the assessment. It was unclear as to whether all three criteria were required to be met collectively or individually. It may be interpreted as the PRA only being prepared to countenance such a change when it has a material impact on a firm's solvency ratio. That implies that for a given change in risk free rates some firms may be allowed to increase their TMTP and others not. We understand the desire of PRA to limit re-approvals in this way but this would not seem consistent treatment of the industry.

20. We believe that the 50 bps change in risk free rate trigger in 2.11 is too high, and 25 bps would be more reasonable. However, whilst helpful indicators such as the 50bps guide firms, as noted above the impact of such movements may vary significantly from firm to firm. We therefore believe it would be more appropriate for firms to develop their own policy on the triggers for recalculation which can allow for their own specific circumstances.

21. We found the other examples of changes in risk profile helpful. We note one change is disposal of pre-1 January 2016 business. It would be useful to say something on acquisition of such business, an area where the PRA has previously recognised that transfers of business within the UK should, in theory, be able to retain the benefits of a pre-existing TMTP subject to the situation of the receiving firm.

Concluding remarks

22. This development is clearly of overall benefit to the industry in helping to manage interest rate risks as they crystallise through the design of the risk margin and in other areas where SII and the existing Solvency 1 regime materially differ. However as drafted, we feel the consultation only partially addresses the issues and may not give firms the timely and practical process needed for the TMTP to be an effective part of their risk management.

23. It may also inhibit risk management on a SII basis and encourage some firms to manage their risk on a Solvency 1 basis. So all firms can benefit from this, we suggest the supervisory statement has clearer signposting of this regulatory stance if this is intended. The PRA

should clarify the impact of using the TD as a hedge for the risk margin so that residual risks are managed on a Solvency I basis. One issue this raises is that sensible “economic” hedging that works for SII and ICA may not work for Pillar 1. This might serve to restrict such sensible hedging or result in greater TD restrictions (from the Pillar 1 FRR restriction). We raise this as a potential issue that needs to be addressed, e.g. by disallowing this from the Pillar 1 restriction.

24. We would also suggest that it would be appropriate to anticipate future TD resets in solvency monitoring or interim reporting, particularly as some resets will be mandatory. Without this, firms’ solvency positions would be subject to potentially large changes at the point of reset. It would seem preferable to anticipate future resets to ensure a smooth solvency progression.

25. We have noted in our response additional areas that would benefit from further clarity in the supervisory statement, including where it potentially creates inconsistent treatment of firms.

26. The IFoA is currently setting up a working party focussing on the TMTP, with the aim of developing a pragmatic approach to its ongoing management. This consultation will be helpful to the work of the working party. We had also updated the PRA on our plans for this working party at the PRA/ IFoA technical meeting on 12 February 2016. We look forward to engaging with the PRA on practical issues through the working party.

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely

Colin Wilson
President-elect, Institute and Faculty of Actuaries