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Solvency II

Regulatory update: From LIBOR to SONIA…the clock is ticking

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GBP SII Technical Information proposed to transition from being LIBOR-based to SONIA-based on 31 July 2021

GBP RFR curve will fall

Change in measure of LTAS

Estimated day 1 solvency ratio impact of less than 5%

Partially mitigated by TMTP recalculation at YE21

Gradual impact, day 1 will be immaterial

The London Interbank Offered Rate ('LIBOR') **will be discontinued by year-end 2021** and, for GBP, replaced with the Sterling Over Night Indexed Average ('SONIA') (see our previous articles on this topic here and here). In relation to this, the PRA released its first consultation paper ('CP') of the year, CP 1/21 'Solvency II: Deep, liquid and transparent assessment, and GBP transition to SONIA'.

The CP outlines the PRA's proposed approach to deep, liquid, and transparent ('DLT') assessments and the transition of SII technical information ('TI'), including the risk-free rate ('RFR') curve and fundamental spreads ('FSs'), that are currently based on LIBOR and will soon be SONIA-based. This TI, which was produced and published by EIOPA pre-Brexit, is now produced and published by the PRA.

CP 1/21 sets out the PRA's preference for TI to be with reference to SONIA-based swaps **from 31 July 2021**. The PRA proposes an immediate shift to SONIA, without the use of a 'blended approach' as proposed by EIOPA.

Firms need to take action now to ensure any solvency and operational impacts are managed appropriately.

Assessment of the depth, liquidity, and transparency of the market

CP 1/21 addresses how the PRA will conduct DLT assessments in a post-Brexit world. The PRA intends to use the results of EIOPA's most recent assessment (16 December 2020) for current risk-free rates until the transition to a SONIA-based RFR curve on **31 July 2021**, but to conduct its own DLT assessment for GBP SONIA-based swaps in the first half of 2021 in preparation for the transition.

Two principal indicators are used for the DLT assessment, both calculated over one year:

1. at least €50m notional average daily turnover
2. average of at least 10 daily trades

In a (very) subtle move away from EU legislation, the PRA proposes that the first of these be calibrated with reference to at least £45m, as opposed to EIOPA's €50m. In other respects, the PRA indicates that it intends to maintain reasonable alignment with EIOPA.

Transition of Solvency II technical information

TI required for UK insurers' balance sheet management, such as RFR curves and FSs in varying currencies, is now published by the PRA. The transition from LIBOR to SONIA will affect the production of the TI, as described below.

Credit risk adjustment

Under SII, the RFR calculation incorporates a credit risk adjustment ('CRA') to adjust for the credit risk embedded in term rates such as LIBOR. As SONIA is based on overnight deposits, the PRA considers the residual credit risk to be immaterial for the purposes of determining risk-free curves and so the CRA will no longer be required.

Long-term average spread

The long-term average spread ('LTAS') used in the calculation of the matching adjustment ('MA') and volatility adjustment ('VA') is currently based on a 30-year historic average spread over LIBOR. The PRA proposes that the LTAS calculation should reflect the change in spreads over risk-free that will result from the transition to SONIA. However, the historic spreads already embedded in the LTAS calculation are proposed to remain unadjusted. The PRA feel this best reflects the requirement for the LTAS to be based on historic data, as well as the practical challenges of adopting any other approach.

The change to the LTAS calculation will result in a very gradual change in the LTAS measure, so the day one impact to the MA is expected to be immaterial. Over time, however, the LTAS will increase, which will result in a higher FS where the LTAS is biting and, all else being equal, this will lead to a lower MA.

Below we discuss the possible impacts of the transition to SONIA on key elements of the balance sheet and the operations of the business.

How the transition will affect technical provisions

From 31 July 2021, the RFR curves in GBP produced by the PRA will switch from the LIBOR-based swap rate with a CRA applied to SONIA-based swaps with no CRA applied. The GBP RFR curve is currently higher than the equivalent SONIA-based curve, as seen from the chart below, and so this will result in an immediate reduction in the RFR curve. **Positive TPs discounted at risk-free, including the risk margin, will therefore increase in value.**

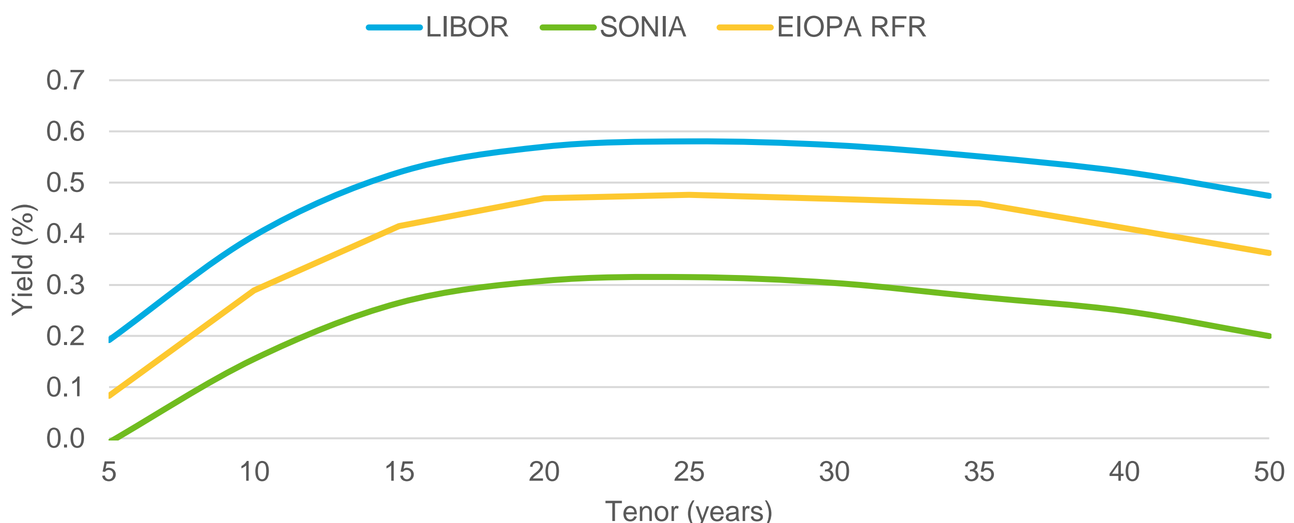

Figure: GBP LIBOR, SONIA and EIOPA RFR curves as at 31/12/20. Sources: Bloomberg, EIOPA

The PRA expects the change in the GBP RFR to result in significantly less than a 5% reduction in the solvency coverage ratio for most firms and, therefore, does not expect a TMTP recalculation to be immediately triggered. The PRA states that business written pre-Solvency II will be eligible for transitional relief at the 31 December 2021 biennial recalculation of the firms' transitional measure for technical provisions ('TMTP'). However, business written since 1 January 2016 will not benefit from any relief.

The PRA states that it will publish indicative SONIA-based TI for GBP ahead of the transition date and following the publication of the final policy statement resulting from this CP. This indicative TI should be used to quantify the expected balance sheet impacts arising from the transition to SONIA-based TI. However, this does not provide much time before the transition to SONIA-based TI on **31 July 2021**.

How the transition will affect your matching adjustment

The matching adjustment itself will increase to offset the reduction in the risk-free rate. This is one of the main reasons why the impact of the change on solvency coverage is expected to be small.

Some MA firms may also have assets that reference LIBOR, such as floating-rate bonds paired with interest rate swaps. As recommended by the Bank of England's RFR working group, the benchmarks referenced by these assets will also transition to SONIA (for GBP-denominated assets).

The PRA states that this change of benchmark itself does not constitute a new feature and so this will not require a reapplication. However, references to the LIBOR benchmark should be updated to reflect the transition to SONIA during the firm's next MA reapplication.

How the transition will affect your internal model

The PRA states that, in accordance with the PRA Rulebook, firms with approval to use an internal model ('IM') must ensure the ongoing appropriateness of the design and operations of their IM and that the IM continues to reflect the risk profile of the firm. We do not anticipate that firms will rush to overhaul their interest rate risk calibrations in response to the change. However, we would expect the transition to SONIA to be considered as part of model validation. Other risk calibrations that are linked to risk-free rates, for example credit spreads and gilt/swap spreads, will also demand at least some consideration.

Commercial and operational impacts

Implications of the switch to SONIA beyond the regulatory balance sheet should not be overlooked. Where firms have complete control over their processes, transition should be relatively simple. However, where arrangements with third parties are linked to swaps, transition may require negotiation.

How Hymans Robertson can support you

Hymans Robertson has a wealth of experience in Investment & ALM and Risk & Capital Management. We are happy to discuss any aspect of LIBOR transition with you.

If you would like to discuss with one of our specialists, please get in touch.

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