HYMANS ROBERTSON

Solvency II newsflash

Error SS6/16: Transitional Measures down for Maintenance

While the EU Referendum and the US Presidential elections may have dominated the national headlines in 2016, the Transitional Measure on Technical Provisions (TMTP) was never far from the spotlight in financial services circles: from consultations to supervisory statements, through turbulent economic conditions and much-needed recalculations. And it is against that backdrop that the Prudential Regulation Authority (PRA) has issued for consultation some proposed amendments to Supervisory Statement 6/16 in which it clarifies its expectations for maintaining the calculation of the TMTP.

In what we expect to be a welcome set of clarifications from the PRA, there are three main areas of focus:

- firms should understand and analyse the main drivers of the TMTP with a view to improving the quality of their risk management practices;
- the PRA's expectations relating to ensuring ongoing consistency between firms Solvency I and Solvency II valuation bases; and
- clarification of the PRA's expectations relating to the use of approximations.

Analysis of drivers of TMTP

For business written before 1 January 2016, the TMTP provides relief from the increase in technical provisions resulting from the introduction of Solvency II on that date. Where the TMTP makes a material contribution to own funds, the PRA expects firms to analyse and understand the main components and drivers of the TMTP benefit as part of their own risk and solvency assessments. This is aimed at driving up the overall quality of risk management, and should include how the components may change over time under a wide range of operating conditions.

Consistency between the Solvency I and Solvency II valuation bases

Firms have previously voiced concerns that, in managing the TMTP on an ongoing basis, both the Solvency I Pillar 1 and Solvency I Pillar 2 (Individual Capital Adequacy Standards – ICAS) valuations would need to be maintained throughout the 16-year transition period.

This does rather seem to be underlined by the current consultation, which explicitly requires firms to ensure that changes in the Solvency II best estimate assumptions which are made for operational reasons (i.e. in light of emerging experience and future expectations) are reflected consistently in the Solvency I assumptions. This applies both to the ICAS valuation as used for the primary comparison and the Pillar 1 valuation as used in the Financial Resources Requirement (FRR) underpin test where the latter could bite.

The PRA's intervention, to clarify the matter of whether the ICAS technical provisions basis can and should be kept up to date, is likely to be welcomed by firms. The conclusion reached seems to be broadly sensible: it would be pointless for a firm to keep its Solvency II basis up to date if any resulting change in technical provisions was immediately cancelled out by a corresponding change in the TMTP. It is, however, unclear whether the principle of maintaining consistency between Solvency I and Solvency II also applies to the capital requirements in the FRR test: do any changes to an internal model also need to be reflected in the calculation of the ICAS capital requirement?

Maintaining consistency between Solvency I and Solvency II will also be more burdensome for firms than fixing the ICAS basis at 1 January 2016 would have been. Some firms pre-emptively reduced this burden by aligning Solvency II and ICAS methodologies and assumptions where appropriate, but nevertheless few have identical approaches. Indeed the PRA is at pains to point out that "consistency" need not require assumptions to be the same, especially bearing in mind that in reviewing firms' ICAS valuations and setting Individual Capital Guidance (ICG) regard was had to the strength of the overall valuation.

In simple terms this means that if a firm had ICG on account of its ICAS best estimate assumptions being considered to be weak, and strengthened its Solvency II best estimate assumptions compared to those used in ICAS, then equalising the ICAS and Solvency II assumptions by strengthening the latter may effectively lead to a double-counting of ICG. That said, the PRA has said that it is willing to consider a proportionate review of ICG in future years if firms believe that the assumptions underlying the most recent ICAS review are out of date. Equalising ICAS and Solvency II assumptions may be one such reason for firms to instigate such a review.

Ongoing maintenance of approval conditions

In terms of maintaining the TMTP, the PRA fully recognises that "a proportionate approach in the calculation of the TMTP may involve the use of estimates" but it requires such simplifications to be clearly documented and not to result in a systematic distortion of the amount of TMTP claimed. It remains to be seen whether the approximations companies currently use or intend to use will satisfy these criteria in practice.

The PRA has also stated that firms will need to differentiate between assets and liabilities applicable to business written before and after the introduction of Solvency II. This is unlikely to have come as much of a surprise to firms but it will leave them anxious to find out the level of detail that the PRA expects when it comes to hypothecating assets to pre- and post-1 January 2016 business and whether firms' proposed solutions are acceptable.

One area where the wording of the Solvency II rules is somewhat ambiguous is whether the FRR test should include business written after 1 January 2016. Restricting the FRR test to pre-2016 business would certainly seem to be more in keeping with the purpose of the TMTP, and the PRA's latest intervention seems to point firms in that direction – although the update to the supervisory statement is not explicit on this point.

In deciding to grant (or otherwise) a request to recalculate the TMTP, the PRA will be considering first and foremost whether or not a firm's risk profile has changed materially. Under the proposed changes, firms' Audit Committees will have a key role to play, both in forming an independent opinion on whether or not the other conditions for TMTP approval continue to be met and, because a recalculation affects the valuation of technical provisions, in assessing against Article 56 of the Delegated Acts the appropriateness of any simplifications used.

Companies have until 15 March 2017 to provide any comments on the proposed amendments.

Hymans Robertson has a wealth of relevant life insurance experience, from risk and capital optimisation under Solvency II, through to broader areas such as model calibration and validation in the areas of longevity risk, credit risk, and dependency & aggregation.

Our experts would be delighted to support you. If you would like more information or advice, please get in touch

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