Institute and Faculty of Actuaries

31 March 2021

PRA CP1/21 Solvency II: Deep, liquid and transparent assessments, and GBP transition to SONIA IFoA Response

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

Key points

The Institute and Faculty of Actuaries welcomes the PRA's proposals in relation to the transition from LIBOR to SONIA risk-free rates. Any such transition from LIBOR should encourage insurers to make the switch from LIBOR to OIS in their asset portfolios with minimal disruption to markets, to avoid artificial volatility in insurers' balance sheets during any transition period, and to mitigate any adverse impact on solvency.

We note the PRA's proposal to publish a SONIA-based risk free curve from 31 July 2021. To help encourage an orderly transition, we suggest the PRA should consider publishing SONIA rates with immediate effect.

We also note that PRA have discounted the use of a blended LIBOR/ SONIA approach on the basis of expected reducing liquidity of LIBOR swaps over 2021. However, we recommend that insurers should be free to select:

- to use either the LIBOR-based or SONIA-based curves, or any blend of the two, over 2021; or
- their own point of transition, with the PRA allowing the use of either risk-free rate over a limited period of time.

The change from LIBOR- to SONIA-based discounting in SII is driven by the wider reform of interest-rates and not by any perception that existing SII discounting rates are too high, so the change should ideally have a minimal impact. Therefore, we believe there is an argument for an upwards adjustment to SONIA rates for use in the SII discount rate. We would support a fixed upwards adjustment to SONIA rates in the discount curve based on 50% of the recent historic average spread between the curves for a typical insurance profile.

We welcome the PRA's proposal that any impact of the transition from LIBOR to SONIA risk-free rates would be in-scope, in principle, of the Transitional Measure on Technical Provisions TMTP. However, we note that the proposed use of this offset through the TMTP has a number of complications, which we believe could make the approach impractical. Although we acknowledge that simplifications to the TMTP recalculation could be agreed with the PRA, this would add to the administrative burden on both firms and the PRA. Instead, we suggest that the PRA propose a simplified approach for all firms at outset.

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1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's Consultation Paper (CP) 1/21 on *Solvency II: deep, liquid and transparent assessments, and GBP transition to SONIA*. In developing our response, we have drawn upon input from a range of members working in long term insurance.

2. We have also reflected on our recent submission to HMT and their Call for Evidence to their review of Solvency II (SII). As the PRA note in CP1/21, the scope of HMT's review included the transition from London Inter-bank Offered Rate (LIBOR) risk-free rates.

3. It is important to note that, as for any IFoA response, we have considered the PRA's proposals from an independent, public interest perspective.

4. We support the PRA's proposals in relation to the transition from LIBOR to SONIA risk-free rates. Any such transition from LIBOR should encourage insurers to make the switch from LIBOR to OIS in their asset portfolios with minimal disruption to markets, to avoid artificial volatility in insurers' balance sheets during any transition period, and to mitigate any adverse impact on solvency.

5. In CP1/21, the PRA propose to publish a SONIA-based risk free curve from 31 July 2021. To help encourage an orderly transition, we suggest that the transitional period over 2021 be as long as possible. Therefore, the PRA should consider publishing SONIA rates with immediate effect.

6. We note that PRA have discounted the use of a blended LIBOR/ SONIA approach on the basis of expected reducing liquidity of LIBOR swaps over 2021. However, we recommend that insurers should be free to select:

   - to use either the LIBOR-based or SONIA-based curves, or any blend of the two, over 2021; or
   - their own point of transition, with the PRA allowing the use of either risk-free rate over a limited period of time.

7. These options would help avoid artificial volatility as insurers transition hedges, and may also avoid any market impact from introducing a change of discount curve on one day (which might incentivise insurers to then shift hedges at the same time).

8. For a SONIA-based curve, a zero credit risk adjustment deduction would seem most appropriate for the basic risk-free rate given the designation of SONIA as near-risk free. The new near-risk-free reference rates have been developed in each country by national working groups following the lead of the G20 and the Financial Stability Board from 2014, using overnight rates which are robust and anchored in active, liquid underlying markets.

9. However, we believe there is an argument for an upwards adjustment to SONIA rates for use in the SII discount rate. The change from LIBOR- to SONIA-based discounting in SII is driven by the wider reform of interest-rates and not by any perception that existing SII discounting rates are too high, so the change should ideally have a minimal impact. Although CP1/21 suggests that any impact could be covered in the Transitional Measure on Technical Provisions (TMTP), this only supports pre-2016 business.

10. The original credit risk adjustment was based on an approximation to 50% of the spread between IBOR and OIS rates, reflecting the greater illiquidity of IBOR rates versus overnight bank deposits.

11. We would support a fixed upwards adjustment to SONIA rates in the discount curve based on 50% of the recent historic average spread between the curves for a typical insurance profile. This would avoid any short term adverse impact on insurers' balance sheet, and could apply temporarily on a

transitional basis to business written pre the planned change in discount curves in 2021. This approach would also be consistent with that applied on the asset side of insurer's balance sheet via the ISDA fallback protocols.

12. We welcome the PRA's proposal that any impact of the transition from LIBOR to SONIA risk-free rates would be in-scope, in principle, of the TMTP. However, we note that the proposed use of this offset through the TMTP has a number of complications, which we believe could make the approach impractical.

13. In our view, more detail on how the TMTP update would work in practice would be helpful. In particular, it is not clear to us how the TMTP recalculations would operate after the end of 2021. Given that LIBOR will cease to exist beyond this date, it will not be possible to calculate the ICA Pillar 2 Best Estimate Liability using an IBOR-based curve.

14. For similar reasons, it is unclear how the Financial Resource Requirements (FRR) test would work in practice. These complications would be further exacerbated when other currencies transition to OIS-rates at different times.

15. Although we acknowledge that simplifications to the TMTP recalculation could be agreed with the PRA, in line with PRA Supervisory Statement (SS) 6/16, this would add to the administrative burden on both firms and the PRA. Instead, we suggest that the PRA propose a simplified approach for all firms at outset.

16. For example, the IBOR transition impact on technical provisions could be calculated as a separate adjustment at the transition date, and then run-off linearly over a period of 10 years (i.e. in line with the TMTP), without regular recalculation. This adjustment could be independent of the FRR test.

17. In addition, we suggest that the offset applies to all business in-force at the transition date, as we see no reason for excluding in-force business written between 2016 and 2021.

18. Rather than waiting for the biennial TMTP recalculation, we suggest that (where relevant) firms should have the option to apply for TMTP recalculation at the point of the (risk-free rate) transition.

19. It would be useful to clarify that insurers do not need to hold basis risk capital in internal models versus LIBOR or SONIA risk during the transition period, again to ease transition.

20. Furthermore, as per PRA SS3/17, the minimum deferment rate in the effective value test is set by the PRA with regard to long-term real risk-free interest rates from swap markets. When the risk-free curve moves from LIBOR to SONIA, we believe the minimum deferment rate should be reduced accordingly.

21. CP1/21 also includes the proposal that, for the next 24 months, the 'PRA relevant currencies' are GBP, USD, EUR, CAD, SEK, AUD, JPY, NOK and DKK, for which the PRA will provide the market with risk-free rates. Some UK insurers may have liabilities in other currencies, and clarity from the PRA on what UK insurers should do for non-PRA relevant currencies would be helpful. Potential options here could include the PRA providing a market reference so that insurers can refer to this source for these wider currencies, or for insurers to use such rates sourced from EIOPA.

22. It would also be helpful if the timing of the PRA's publishing of risk-free rates were aligned with EIOPA's timing. At Year End 2020, there was a one week 'lag' after the EIOPA rates were available before the equivalent PRA rates were published, which was problematic.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk) in the first instance.

Yours Sincerely,

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President, Institute and Faculty of Actuaries