Bank of England PRA

Solvency II: Calculation of technical provisions

Supervisory statement | SS8/24

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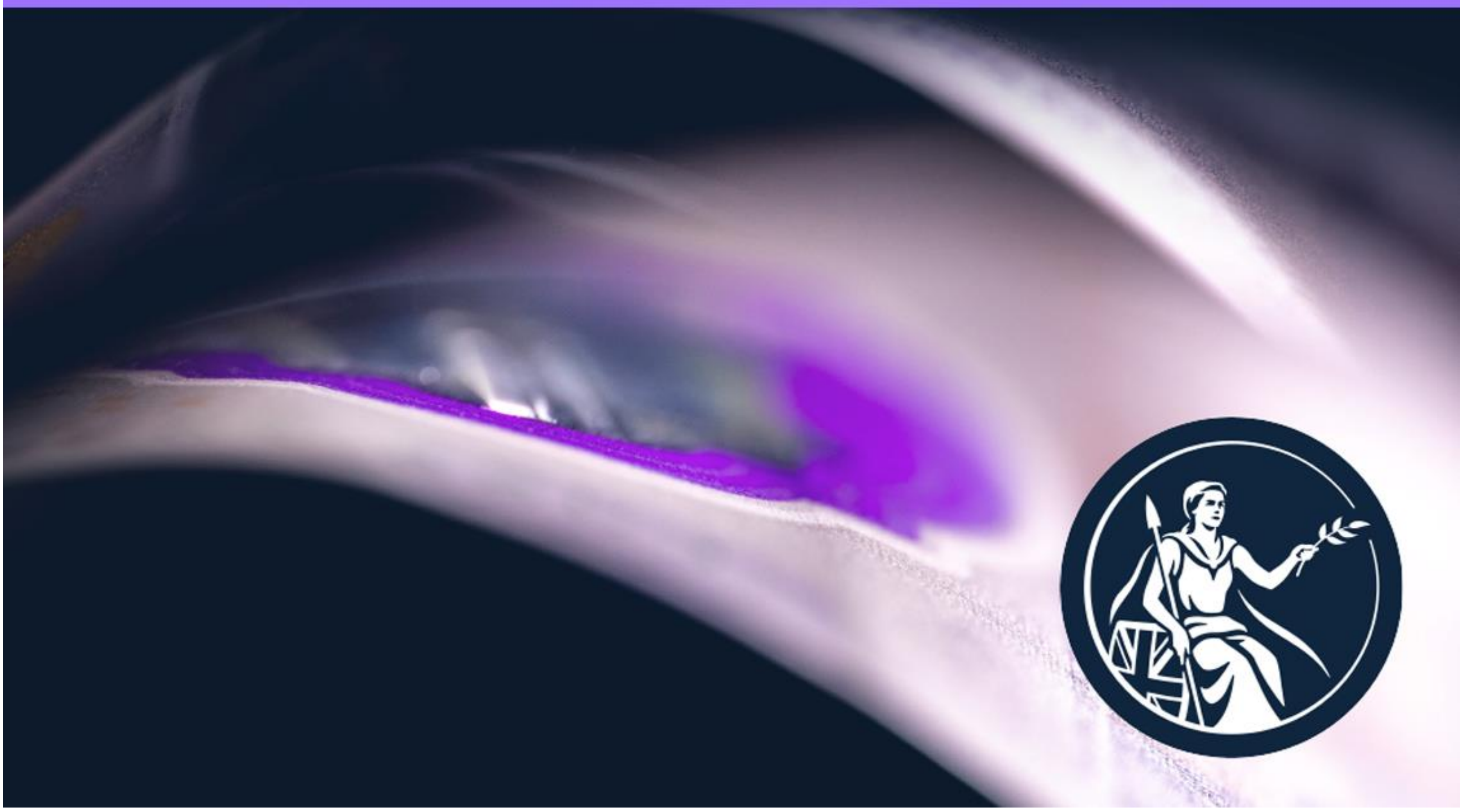

Contents

1: Introduction

1.1 This supervisory statement (SS) sets out the Prudential Regulation Authority's (PRA) expectations in respect of how insurers should calculate their technical provisions, expanding on the rules set out in the PRA Rulebook.[1]

1.2 This SS is relevant to all UK Solvency II firms, the Society of Lloyd’s, its members and managing agents. This SS refers to these collectively as ‘insurers’ or ‘firms’ unless otherwise specified.

1.3 In addition, part 2 of this SS is also relevant to third-country insurance undertakings that have a UK branch (third-country branch undertakings) who should read any reference to ‘technical provisions’ as ‘the provisions referred to in rule 6.1 of the Third Country Branches Part of the PRA rulebook’, and other references to the PRA Rulebook with the necessary modifications.

1.4 This SS seeks to advance the PRA’s statutory objective of promoting the safety and soundness of the firms it regulates by setting out the PRA’s expectations of how insurers should calculate their technical provisions and Solvency Capital Requirements.

1.5 In line with Technical Provisions – Further Requirements 27 (Proportionality), insurers are expected to ensure the methods used to calculate technical provisions are proportionate to the nature, scale and complexity of the risks underlying their insurance and reinsurance obligations.

1.6 Furthermore, Technical Provisions 2 (Calculation of Technical Provisions) sets out general principles firms should comply with when calculating their technical provisions.

1.7 It is important that firms consider carefully whether the methods used in their technical provisions calculations comply with the Technical Provisions rules,[2] including that they are in fact proportionate. The following sections set out the PRA’s expectations in respect of insurers applying simplifications to the best estimate and risk margin elements of the technical provisions.

1 Including the Technical Provisions and Technical Provisions – Further Requirements Parts of the PRA Rulebook.

2 The Technical Provisions and Technical Provisions – Further Requirements Parts of the PRA Rulebook.

2: Best estimate

Simplified calculation of recoverables from reinsurance contracts and special purpose vehicles

2.1 Where appropriate, firms may calculate the amounts recoverable from reinsurance contracts and special purpose vehicles before adjusting those amounts to take account of the expected loss due to default of the counterparty as the difference between the following estimates:

(a) the best estimate calculated gross as referred to in Technical Provisions 3.1(2)(c); and

(b) the best estimate, after taking into account the amounts recoverable from reinsurance contracts and special purpose vehicles and without an adjustment for the expected loss due to default of the counterparty (unadjusted net best estimate) calculated in accordance with paragraph 2.2.

2.2 Firms may use methods to derive the unadjusted net best estimate from the gross best estimate without an explicit projection of the cash flows underlying the amounts recoverable from reinsurance contracts and special purpose vehicles. Firms may calculate the unadjusted net best estimate based on homogeneous risk groups. Each of those homogeneous risk groups should cover not more than one reinsurance contract or special purpose vehicle unless those reinsurance contracts or special purpose vehicles provide a transfer of homogeneous risks.

Simplified calculation of the best estimate for insurance obligations with premium adjustment mechanism

2.3 Where appropriate, firms may calculate the best estimate of long-term insurance business obligations with an arrangement by which the firm has the right or the obligation to adjust the future premiums of an insurance contract to reflect material changes in the expected level of claims and expenses (premium adjustment mechanism) using cash flow projections. These projections must assume that changes in the level of claims and expenses occur simultaneously with premium adjustments and result in a net cash flow that is equal to zero, provided that all of the following conditions are met:

(a) the premium adjustment mechanism fully compensates the firm for any increase in the level of claims and expenses in a timely manner;

(b) the calculation does not result in an underestimation of the best estimate; and

(c) the calculation does not result in an underestimation of the risk inherent in those insurance obligations.

Simplified calculation of the calculation of the counterparty default adjustment

2.4 Where appropriate, firms may calculate the adjustment for expected losses due to default of the counterparty, referred to in Technical Provisions 11.1, for a specific counterparty and homogeneous risk group to be equal as follows:

$$Adj_{CD} = -\max\left(0.5 * \frac{PD}{1-PD} * Dur_{mod} * BE_{rec}; 0\right)$$

where:

(a) PD denotes the probability of default of that counterparty during the following 12 months;

(b) Dur_{mod} denotes the modified duration of the amounts recoverable from reinsurance contracts with that counterparty in relation to that homogeneous risk group; and

(c) BE_{rec} denotes the amounts recoverable from reinsurance contracts with that counterparty in relation to that homogeneous risk group.

3: Risk margin

Simplified calculation of the risk margin

3.1 Where appropriate, firms may use simplified methods when they calculate the risk margin, including one or more of the following:

(a) methods which use approximations of the amounts denoted by the terms SCR(t) referred to in Technical Provisions 4A.1 (Calculation of the Risk Margin); and

(b) methods which approximate the discounted sum of the amounts denoted by the terms SCR(t) as referred to in Technical Provisions 4A.1 (Calculation of the Risk Margin) without calculating each of those amounts separately.

Calculations of the risk margin during the financial year

3.2 Where appropriate, firms may derive the risk margin for calculations that need to be performed quarterly from the result of an earlier calculation of the risk margin without an explicit calculation of the formula referred to in the PRA Rulebook.