Solvency II and the way it has been implemented in the UK

Section 3 of the report explores how Solvency II has been implemented in the UK. The overwhelming view of respondents (and of the Committee) appears to be that:

- Solvency II is a generally sound regime (much of it being built on the UK's earlier ICAS regime);
- The industry does not want to throw it away and start again;
- It has improved risk management disciplines; but
- There are significant weaknesses that can be improved

Many industry respondents seemed to believe that the PRA had not been proportional in its implementation of the regime. The Committee itself is worried that:

> " the UK's detailed approach to the implementation of the rules-based Solvency II Directive may have erred on the side of caution, enhancing policyholder protection at the expense of increasing the cost of capital for UK insurers. In any event, the PRA should give greater consideration to how it can maximise its application of proportionality."

The Report explores disagreements between the ABI and the PRA over 23 specific suggestions where the ABI believes the regulator has the power to act to amend its implementation of the Solvency II regulation for the benefit of the insurance industry and ultimately, the customer. The PRA disagreed with 8, agreed with 5 and was somewhere in the middle for the remaining 10. The Committee wants the PRA to make substantive progress with the suggestions that it agrees with and to take a fresh look at those that it does not in the context of Brexit.

The report (in paragraph 88) presents a shopping list (see page 8) of topics the Committee wants the PRA to explore (in close collaboration with the industry) and expects the PRA to report back to the Committee by 31 March 2018 on them, setting out time constraints and considering the end goal (including areas that can be developed after Brexit). The Committee sees the end goal as:

> " a system of regulation which is right for the UK insurance industry and which meets the current and future needs of customers, providing a prudent regulatory structure without stifling competition and innovation."

Financial stability and market distortions

The Report refers to potential procyclical behaviours deemed to be encouraged by Solvency II due to the capital that insurers need to hold to protect against equity and property market falls.

> " Because a typical cause of reduced solvency is falling markets, there is a danger of a vicious circle: markets fall, insurers are forced to sell, which causes markets to fall further, in a process called 'procyclicality'"
>
> HOUSE OF COMMONS TREASURY COMMITTEE

The Committee would like any post-Brexit regulatory model to be more flexible than the current Solvency II arrangements in allowing temporary rule amendments in the event of a severe financial crisis.

Effect on long term savings and investment

Section 5 of the Report concentrates on the Matching Adjustment (MA). The Report notes that, unlike most of their Continental European counterparts, UK insurers have sold large volumes of annuity products with relatively predictable liability cash flows. A key role was played by HM Treasury and the PRA in introducing the MA mechanism into the original Solvency II proposals, allowing insurers to take some credit for the illiquidity premium deemed to be accessible by investing in illiquid assets that generated corresponding matching cashflows.

> However, the MA is perceived as incorporating "stringent restrictions and constraints required by a sceptical non-UK audience designed to prevent it from being 'misused'" and to be too restrictive and overly engineered, since "with the exception of Spain, the UK is the only country to use the Matching Adjustment".

Industry respondents argued that there were several problems with the MA, creating reduced competition in the annuity and equity release markets, extra costs in complying with the rules, loss of access to some asset types and poorer value for customers. The Committee broadly agreed with these respondents.

In contrast, the PRA seemed to think that the industry had put its case much too strongly. It noted that there were factors such as a lack of availability of such assets which were holding back (or were likely to constrain) outsized intentions on the part of the industry to target such assets.

The PRA also noted that in practice it had introduced workarounds (such as allowing firms to securitise cash flows) which allowed 80 – 90% of desired cash flows to be eligible. So, while they were "stuck with the rules as they are written", they were "trying to operate them in as flexible a way as possible". The Committee accepts that the MA has given some relief to the industry, but views it as a "workaround" solution. It thinks the PRA needs to conduct a fundamental review of the MA and its eligibility criteria, to achieve a more principles-based approach to the MA.

The Risk Margin

Section 6 of the Report notes widespread agreement that calibration of the Risk Margin is a significant bug in the existing Solvency II framework. Industry respondents raised numerous ways in which the Risk Margin is flawed. Even the PRA believes that it is "overcooked". Where the industry and regulator diverge is on the best course of action to address the Risk Margin. The industry appears to want action now, whilst the PRA appears to want to seek changes to the Risk Margin methodology within the wider European due process.

The Committee agrees that a Risk Margin does make conceptual sense. However, it notes that the flaws referred to above are resulting in UK business being reinsured overseas and the mitigation available from Transitional Measures is falling away. The Committee agrees with many industry respondents that the PRA should be taking action now, rather than waiting for the uncertain outcome of the broader review currently being undertaken by EIOPA and the European Commission which seems unlikely to bring change.

Proportionality

Section 7 of the Report explores areas where there is considered to be scope for greater proportionality on the part of the PRA. The Committee thinks that in theory the legislation allows for a significant amount of 'proportionality' but in practice encourages a detailed rule based approach to implementation which a cautious and professional regulator such as the PRA has found difficult to resist. Two specific examples highlighted by submissions were in relation to (i) internal models and (ii) data requirements.

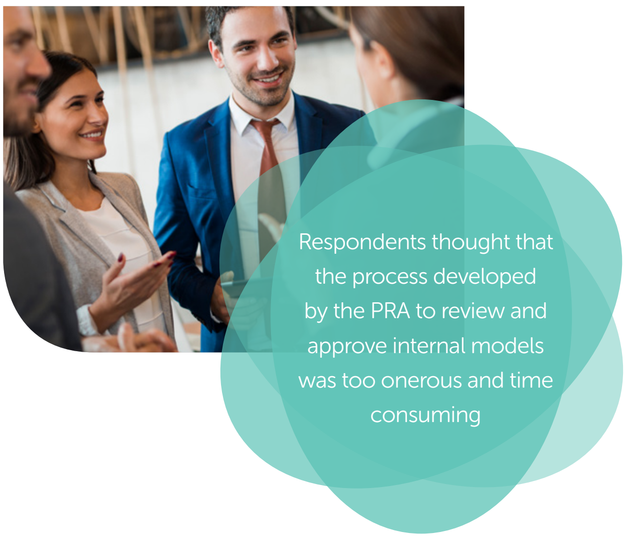
> On internal model validation and approval, a focus on large complex internal models has led to a detailed and expensive validation process.

Many respondents thought that the process developed by the PRA to review and approve internal models was too onerous and time consuming. Insurers who had already obtained approval were finding that the process for getting changes approved could also take several months, constraining their commercial flexibility.

The Report notes "widespread and consistent concerns expressed by firms over the proportionality of the PRA's approach, particularly with regard to the review and approval of internal models and amendments to these models. The PRA is urgently asked to review its practices and report to the Committee on proposed changes."

> A parallel approach some Committee witnesses suggested was to refine the Standard Formula so that it catered better for affected firms. The Report recommended that the PRA also explore this possibility.

The Report also noted the quantum leap in magnitude of regular reporting versus the previous regime. The feeling was that the Solvency II regular reporting requirements were costly and overly detailed. Even the PRA seemed to accept that this was "probably the most consistent theme across the shop". The Committee believes that reporting can be streamlined, reducing the burden and cost on firms and reducing the risk that the PRA could miss something. It made some generic suggestions such as focusing more on exception reporting and/or focusing on change versus previous information.



Other technical matters

Several more technical matters are covered in Section 8 of the Report, namely:

a. The Volatility Adjustment. Bearing in mind the action of some other regulators, notably the Dutch, the Committee would like the PRA to amend how the Volatility Adjustment is applied in the UK, although it was not specific in its desired changes.

b. The Transitional Measure on Technical Provisions (TMTP). The Committee welcomed the PRA's earlier consultation on the TMTP but thinks that some broader issues remain to be addressed, including:

   1. whether and how the transitional benefit should run-off over time

   2. whether the principal causes of the increase in reserves at point of entry of Solvency II can be "corrected" (see comments above on the Risk Margin)

   3. the cost and potential need to maintain dual models for 16 years; and (iv) how to develop an approach which is more practical to implement

c. Contract Boundaries. The Committee would like the PRA to develop rules for contract boundaries that reflect their economic substance rather than their legal form.

d. Use of One Year Value at Risk. Some respondents disagreed with the core one year value at risk concept underlying the Solvency II SCR. The Committee did not make any specific recommendations in this area.

Brexit

Section 9 of the Report explores Brexit-related issues. The Committee thinks that the insurance industry should be regarded as a priority sector during Section 50 negotiations and that a pragmatic approach is vital. One issue is the desirability of obtaining agreement on equivalence or some surer relationship (e.g. via a bespoke treaty) between any post-Brexit UK regime and the then applicable EU regime.

> A Brexit complication noted by several respondents was the legal status of pre-Brexit contracts written either in EU branches of UK firms or written directly by UK firms into the EU.

These contracts might fall outside the scope of a firm's authorisation post Brexit unless action is taken. Also, firms might want to set up new subsidiaries into which they then transfer such contracts, but this might lead to more 'Part VII' transfers than can be practically be handled by the PRA or the Courts. The Committee suggested granting provisional recognition to EU branches prior to Brexit as a possible way of partially addressing this issue.

Final comment

The Report will be seen as a victory by some as the Committee quite clearly accepts the view held by many in the insurance industry that the PRA has "gold plated" certain elements of its implementation of Solvency II. We have already seen the PRA launch a series of improvements to the implementation of Solvency II. It will be interesting to see how far the PRA is prepared to go, and the influence the UK Government will have.

The Committee's "shopping list"

The Committee considers that the PRA, working in close collaboration with the industry, should:

- provide a solution for the Risk Margin to improve its calibration;
- develop proposals for the introduction of forbearance at the national level to deal with procyclicality;
- develop proposals for the Matching Adjustment and the Volatility Adjustment which allow more flexibility and a more principles-based approach and which reduce the requirement for insurers to develop complex structures in order to achieve the regulatory treatment that they warrant;
- agree with the industry on an approach to the treatment of illiquid assets;
- balance prudential concerns with the desire not to create unreasonable barriers to insurers investing in long term assets;
- set out proposals which reduce the amount of data required from firms to the level that the PRA can clearly demonstrate is proportionate and necessary for prudential safety;
- develop rules for contract boundaries which reflect their economic substance rather than their legal form;
- develop proposals for simplifying the calculation of and approval process for, the Transitional Measure on Technical Provisions provided for in the Directive;
- provide a view of where it might be possible better to align UK regulation post Brexit with IFRS17, weighing the disadvantages of change against the benefits of harmonisation;
- develop proposals which remove limitations in the standard formula for both existing and new entrants to the insurance market;
- develop proposals for improving the sophistication and usefulness of internal models by (a) maximising the proportionality allowed in the Directive for the approval of internal models and (b) simplifying the approval process for changes to models; and
- develop a solution for firms who will lose the legal validity of their contracts after Brexit.

We have already seen the PRA launch a series of improvements to the implementation of Solvency II

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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