Government launches review of Solvency II

AT A GLANCE

October 2020

What's new?

- The UK Government launched a Call for Evidence (CfE) on 19 October 2020 which is the first stage in the review of Solvency II post Brexit. The CfE covers the areas outlined by the Chancellor in his speech in June 2020 about plans to review certain features of Solvency II taking into consideration the unique features of the UK insurance sector. The proposals in the CfE also aim to ensure that the UK maintains an internationally competitive insurance sector without compromising policyholder protection and the safety and soundness of firms.
- In the CfE, the Government seeks views as to how the prudential regulatory regime can better enable insurance firms to contribute to the Government's objectives to provide long-term capital to support growth across the UK and the Government's climate change objectives.
- Separately, the Government is conducting a long-term review of the Future Regulatory Framework (FRF) Review to determine how the overall framework for financial services regulation will need to adapt to the UK's position outside the EU. The FRF Review will examine the allocation of regulatory responsibilities between Parliament, HM Treasury and the financial services regulators. See our At-a-glance for further details regarding the FRF Review here.

What does this mean?

- The areas the CfE is focusing on for review are:
  - Risk Margin (RM): The Government intends to work with the PRA to reform the RM and notes that UK life insurers have increasingly reinsured longevity risk (offshore) to reduce the capital strain on their balance sheets created by the RM requirements. The Government is seeking views on changes to the RM methodology including modifying the current 'cost of capital' approach to help reduce the RM's size, volatility and pro-cyclicality.
  - Matching Adjustment (MA): Although the Government supports the MA's objectives, it is now seeking views on whether it is operating optimally including the criteria used to determine the eligibility of assets and liabilities. The Government is interested in the role that the MA could play to better support delivery of its climate, 'levelling up' and long-term investment objectives, including in appropriate infrastructure assets. The CfE also seeks views on the application processes for the use of the MA and options to make the process simpler and more efficient.
  - Calculation of SCR: The Government seeks views on whether the current approach can be made less prescriptive, less complex and to increase the ability of regulators to apply supervisory judgement. Also of interest is the role that the determination of the SCR could play to support delivery of the Government's climate change objectives, the delivery of its Green Finance Strategy and to address the risks posed by exposure to 'stranded assets'.

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- Group Solvency: Current requirements only allow for the use of one group internal model in the calculation of the group SCR. In the CfE the Government seeks views on which issues should be considered to allow for temporary calculation of the consolidated group SCR using multiple group internal models following an acquisition or merger.
- Transitional Measure on Technical Provisions (TMTP): The current application of TMTP deductions requires firms to maintain 'legacy' models. In order to address this issue, the CfE seeks views on alternative specifications for the transitional measure in the context of the wider changes that may result from the rest of the review. Additionally, the Government plans to consider ways in which the specification and calculation of TMTP could be made more proportionate.
- Reporting Requirements: Insurance regulatory reporting comprises several layers: Solvency II templates, National Specific Templates, reporting expectations in supervisory statements, and ad hoc requests. The Government therefore invites comments on what changes could be made to create a reporting framework that is proportionate and balances costs vs benefits.
- LIBOR: The CfE seeks views on any issues arising for insurance firms from the forthcoming switch from LIBOR to Overnight Indexed Swap rates.
- Thresholds for regulation by the PRA under Solvency II: Currently firms with annual GWP over EUR 5 million,and gross TPs over EUR 25 million, are captured under SII. The Government seeks views on the scope of the application of SII.
- Mobilisation of new insurance firms: 'Mobilisation' allows the firm some latitude to become established and grow before the other requirements apply. The CfE seeks views on the mobilisation of new insurance firms, including whether the current regimes contain barriers for new market entrants.
- Branch capital requirements: Government expects a significant increase in the number of insurance firms accessing the UK market through branches in the future. Therefore the Government wants to explore how the branch regime can be reformed in order to increase the attractiveness of the UK as a destination for foreign branches.

What do firms need to do?

- At this stage insurers may wish to consider which of the areas of review set out in the CfE is most relevant for their business and decide if they want to respond. In their response, firms are encouraged to include high quality supporting evidence as well as evidence on the costs and benefits of any proposals.
- Life insurers may wish to monitor the changes to the RM and MA as these are likely to impact their reinsurance, capital management and investment strategies going forward.
- Firms that have applied to enter the Temporary Permissions Regime as well as international firms looking to set up operations in the UK might wish to consider how changes to branch capital requirements could impact their post-Brexit organisational structure.

Next steps

The response period for the CfE ends on 19 January 2021. Some proposed changes arising from this CfE will require further, more technical, consultations by the PRA while other proposed changes may require legislation. Therefore, it is unlikely that any of the proposed changes would come into effect before FY 2022. The Government will set out how the reforms will be taken forward in its response to the call for evidence.