HM Treasury proposes overhaul of insurance prudential regime

AT A GLANCE

May 2022

What's new?

- HM Treasury (HMT) published a consultation paper (CP) on the Solvency II Review on 28 April 2022. It follows HMT's Call for Evidence on Solvency II in October 2020 and sets out more details on the Government's proposed reforms to the prudential regulatory regime for insurers.
- It proposes amendments related to: risk margin; matching adjustment; increasing investment flexibility; and reducing reporting and administrative burdens.
- The CP should be read alongside the PRA's statement on the review of Solvency II and its Discussion Paper (**DP**) on potential changes to Solvency II's RM and Matching Adjustment features.

What does this mean?

Risk margin (RM)

- The Government proposes that the size and volatility of the RM should be reduced as the current methodology can overstate the value of liabilities particularly in low interest rate environments. It adds that a high RM increases insurers' costs of writing new business and leads to suboptimal capital allocation.
- **Long-term life insurers would face a 60-70% reduction in the RM.** HMT proposes to achieve this by reforming the RM's current methodology. The PRA in its DP states that the RM could be recalibrated to reduce its effect in current economic conditions by around 60% for life insurers, but only if accompanied by a significant strengthening of the **fundamental spread (FS)**.
- HMT says that the RM's size and volatility could be reduced by applying either a modified cost of capital methodology or the Margin over Current Estimate model used in the IAIS's Insurance Capital Standard.
- HMT sees merit in the modified cost of capital approach.
- It states that a smaller RM would reduce the financial incentive for life insurers to reinsure longevity risks in non-UK jurisdictions that do not require a risk margin to be held and thus help keep more life insurance premiums in the UK, boosting the economy.
- The Government explains that this would also reduce the supervisory and regulatory risks of reinsuring UK longevity risk overseas.
- Separately, HMT reports that the PRA considers that a **30% reduction in the risk margin for general insurers would be appropriate.** HMT states that different types of insurer may warrant different RM calibrations. It adds that the PRA will provide more detail on its view on this.

Matching adjustment (MA)

- HMT notes that the **MA** allows insurers to recognise unearned future cashflows upfront as part of capital.
- It says that several indicators suggest that the FS - which drives the value of the MA - does not properly capture retained risks, which may lead to policyholders being inappropriately exposed to credit and other retained risks.

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- The Government is considering recalibrating the FS methodology to include a credit risk premium which reflects the uncertainty in future defaults based on current market conditions.
- HMT says that a FS regime incorporating market measures of credit risk should be phased in so that firms can reflect the impact on capital, pricing and investment decisions in an orderly manner.
- It adds that reforming the FS will likely require a re-evaluation of the internal models used to determine the solvency capital requirement.
- The likely impact would be to increase capital requirements for those who benefit from the MA.

Increasing investment flexibility

- HMT's proposals to give insurers increased investment flexibility include **broadening the range of assets eligible for the matching adjustment portfolio** so that the portfolio is not limited to assets with fixed timings and amounts.
- Insurers would be able to include assets - such as callable bonds - which the issuer has the option to repay at an earlier date.
- The proposals also include allowing investments in assets rated below BBB.
- In addition, HMT proposes to extend the range of liabilities eligible for the MA to include income protection and with-profits deferred annuities.

Reducing regulatory burdens

- HMT proposes to empower the PRA to create a **mobilisation regime for new insurers' route to market**.
- This regime would be optional and could entail a lower capital floor and exemptions from some reporting requirements.
- Separately, HMT is considering reducing the quantity and prescriptiveness of internal model standards requirements. It says that this should simplify the internal model framework but keep high modelling standards.
- UK branches of foreign insurers would no longer have to calculate branch capital requirements and hold local assets to cover them.
- The Government proposes doubling the size and complexity thresholds that must be met before Solvency II applies.

What do firms need to do?

- Life insurers should consider how changes to the RM and MA will affect their reinsurance, capital and investment strategies.
- International insurers in the UK should consider how the branch proposals may impact their optimal group structure in the UK.
- Insurers with operations in the UK and the EU will need to consider whether divergences in areas such as reporting requirements will require changes to systems.
- When considering their responses to HMT's proposals, insurers should take into account the PRA's statement on the review of Solvency II and its DP on potential changes to Solvency II's RM and MA features.
- HMT states that changes to the insurance prudential regulatory framework will need further analysis and input from the PRA, which is scheduled to consult on this topic in due course.

Next steps

The consultation closes on 21 July 2022. HMT will consider stakeholders' feedback before deciding which aspects of the Solvency II reforms should be in legislation rather than the PRA's rules.

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