

PRA finalises new Solvency UK framework

HOT TOPIC

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Highlights

The PRA has confirmed major reforms to Solvency II, with minor change to its original proposals. It removes onerous requirements, and increases flexibility and competitiveness.

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Summary

Following the UK's withdrawal from the EU, the UK Government worked with regulators to adapt the UK's financial services regulatory framework to the UK's new position outside of the EU.

Reforms to Solvency II are being delivered through a combination of legislation and PRA rules. Confirming its first step to deliver a tailored UK insurance and reinsurance framework, the PRA issued two policy statements on major reforms to Solvency II on 28 February ([PS2/24](#)) and 29 February 2024 ([PS3/24](#)). The PRA believes the new Solvency UK (SUK) regime will lead to a more competitive and dynamic UK insurance sector, without compromising high standards of policyholder protection. In doing so, the PRA considers its rules will advance its new secondary objective of international competitiveness and growth under the Financial Services and Markets Act 2023.

The PRA's rules are consistent with the Government's [response](#) to its Solvency II review (see our At a glance [summary](#)); and so the PRA's rules should be read with the Government's response. Overall, the PRA expects its new SUK regime will simplify some requirements, allow improved flexibility, and encourage entry into the UK insurance market.

In PS2/24 and PS3/24, the PRA takes forward the proposals it set out in [CP12/23](#) (and in [CP14/22](#) with respect to reporting) to achieve greater flexibility, amongst other things (see our Hot Topic [summary](#) and our At a glance [summary](#)). The PRA confirms a reduction in the number of prescriptive requirements that insurers must meet for approval of their internal models (IMs) and replaces these with a principles-based approach for assessing IMs. There will be more flexibility in the calculation of group capital requirements in certain circumstances. While the PRA received broad support for its proposals, it made some changes and clarifications, the most significant of which are:

- Removing the requirement for insurers to disclose certain capital add-ons and safeguards. This will reduce the burden on insurers and make the regime more proportionate.
- Explicitly allowing for dynamic adjustments to capital add-ons based on risk deviation over time.
- Extending the time period to up to six months for insurance groups to integrate IMs after an acquisition.
- Increasing the Gross Written Premium (GWP) threshold for firms entering SUK from £15m to £25m.
- Confirming the removal of the requirement for firms to carry out the Financial Resource Requirement (FRR) test when recalculating the TMTP, as [announced](#) by the PRA in December 2023.
- Removing some of the new reporting templates proposed in CP12/23, and simplifying the data needed for others.

The PRA's second major Solvency II consultation ([CP19/23](#)) was published in September 2023, which covers reforms specifically relevant to life insurers in relation to investment flexibility and the MA. While PS2/24 and PS3/24 do not cover CP19/23, the PRA confirms it is still planning to have final policy on the MA in place by the end of June 2024.

We discuss the PRA's final rules in PS2/24 and PS3/24 in further detail below.

Transitional measure on technical provisions

The purpose of the TMTP and the transitional measure on the risk-free interest rate (TMIR) is to smooth the financial impact of the transition from the previous Solvency I regime to Solvency II on insurers. TMTP and TMIR allow insurers to apply temporary reductions to the amount of technical provisions for business written before 2016, and increase available capital.

Under the new TMTP method, the PRA states that the TMTP would be derived in each reporting period exclusively from figures produced under Solvency II, and there would no longer be any reliance on Solvency I models.

The PRA amended the wording of its proposed rules to allow insurers flexibility in how MA-eligible business (rather than annuity business) is allocated across the dynamic and non-dynamic components of the new TMTP method. This change is designed to provide insurers with greater flexibility and to help mitigate potential operational complexity.

The PRA expects its rules to reduce the costs associated with calculating the TMTP for insurers and the PRA, and to drive greater consistency in how TMTP is calculated. Further, the rules are expected to put greater focus on insurers' management of the run-off of TMTP during the transitional period, which ends in 2032.

However, the PRA recognises that for some insurers the new TMTP method could have adverse impacts. For example, the new TMTP method could lead to a material financial impact under certain economic scenarios. Therefore, the PRA confirms that insurers affected in this way will be able to apply to vary their TMTP permission to allow them to continue to calculate TMTP using the existing approach, referred to as the 'legacy approach'. Insurers will need to submit an application to the PRA by 30 June 2024 if they wish to continue to use the legacy approach. Following feedback, the PRA confirms it removed the FRR in December 2023, subject to case-by-case assessments, which is one year earlier than it originally intended.

The PRA considers that it would be more proportionate for the Chief Actuary to assume oversight of the TMTP calculation, instead of the Audit Committee. The PRA confirms that the Chief Actuary is also responsible for confirming annually that the TMTP has been calculated according to the approved methodology and has been appropriately reduced in accordance with the applicable requirements.

Internal models

The PRA's rules streamline the tests and standards for insurers to meet when making changes to existing IMs and for new IMs. The current IM framework is highly prescriptive and detailed as it was designed to harmonise regulation across the EU. Following the UK's exit from the EU, the PRA considers insurers can continue to demonstrate high internal modelling standards with less prescriptive rules. The PRA's rules retain certain principle-based requirements, with expectations set out in a Supervisory Statement (SS) which collectively provide greater flexibility and reduce burden for insurers.

The PRA only retains risk management requirements in IM submissions that directly relate to the scope of IMs. Otherwise the PRA removes the requirement to include risk management and governance in IM submissions as the PRA assesses risk management and controls standards through other ongoing supervision means.

Insurers are currently required to maintain a directory of data used in IM frameworks, and this needs to include the source, characteristics and usage of the data. The PRA considers compliance with this prescriptive minimum documentation of data used requirement may be disproportionate in some cases, and therefore replaces this requirement with expectations in a SS.

The PRA further removes the profit and loss attribution exercise from IM validation processes, and replaces this with a new IM requirement for insurers to carry out an annual analysis of change (AoC) exercise. The PRA considers an AoC exercise would be a more efficient tool to understand the changes in solvency capital requirements (SCR) over time, further it is aligned to what insurers regularly do in practice.

The PRA formalises existing arrangements to address residual IM weaknesses by requiring insurers to incorporate model limitation adjustments (MLAs) into their IMs to ensure compliance with the calibration standards. The PRA confirms that MLAs are not the same as expert judgements, and that the use of MLAs should not be excessive. MLAs act to mitigate residual model limitations (RMLs), and therefore the PRA considers that all MLAs should have associated remediation plans so that they do not persist indefinitely.

The PRA additionally implements safeguards. By applying certain safeguards, the PRA will be able to grant IM permission where the IM is substantively sound, but which has RMLs. The PRA introduces two types of safeguards where RMLs exist. The PRA will have the ability to set: 1) an RML capital add-on (CAO) where the deviation from an insurer's or group's risk profile of assumptions underlying the SCR are not considered significant, and 2) a qualitative requirement safeguard that would apply to an insurer's business practices or IM use.

Further, to allow the PRA to check that insurers' IMs remain appropriate, the PRA introduces an internal model ongoing review (IMOR) framework which builds on the PRA's existing supervisory review processes. The IMOR framework consists of four strands: 1) PRA driven thematic work, 2) a new annual report to share the results of the AoC exercise, 3) an annual attestation by the Chief Risk Officer in relation to the IM requirements which would form part of an insurer's IM validation report, and 4) monitoring of the use of any insurer safeguards for which the PRA provided permission.

The PRA clarifies it will allow insurers to make administrative changes to their IM change policy without needing to apply for a variation of permission. The PRA provides some examples of administrative changes which include changes to the name of the company, to role descriptions and to the names of staff responsible for the IM. The PRA also clarifies that following the finalisation of the new IM requirements, it will update the EIOPA self-assessment template within the Common Application Package for IMs. Further, the PRA also confirms it intends to determine the outcome of a complete IM application within six months of receipt.

Capital add-ons

The PRA's rules on CAOs support the PRA's rules for a new flexible approach to IM frameworks. The PRA introduces a

new RML CAO which is as a model permission safeguard, to support the PRA's ability to grant permission to insurers to use an IM with a RML. The PRA further introduces a new approach for calculating a CAO for an IM significant risk profile deviation in exceptional circumstances, where it has concerns that part or all of an insurer's IM is inadequate or the SCR that the IM generates no longer reflects the insurer's risk profile better than if the Standard Formula were used.

The PRA confirms that where CAOs are set at group level, it will consider whether the rationale for the CAO also applies at entity level, and where this is the case, the PRA will consider setting a further CAO at the entity level.

After considering feedback to CP12/23, the PRA clarifies that insurers will not need to disclose RML CAOs set by the PRA within their Solvency and Financial Condition Report (SFCR). Instead, insurers will need to include RML CAOs in the amount of the SCR calculated using its IM and the reported SCR split by risk modules.

In CP12/23, the PRA proposed to publish regular summary reports at an aggregate industry level on its use of RML CAOs and requirement safeguards. However, in PS2/24, the PRA confirms IM permission safeguards will not be included in the regular summary report which will now only include CAOs for significant deviation. To maintain an appropriate level of transparency, the PRA will instead publish a summary report on its use of safeguards in 2027. This report will not identify individual insurers.

The PRA also now explicitly allows for the possibility of setting a CAO which moves dynamically in line with certain outputs calculated by an insurer in order to reflect how the underlying risk deviation varies over time (for example due to changes in the business and economic conditions).

Flexibility in calculating the group SCR

When calculating the consolidated group SCR, the PRA confirms it will allow a group to add the results of two or more different calculation approaches, for a period of up to two years (for example IM and IM; or IM and standard formula). Nonetheless, the PRA states it remains important for a group to develop a single approach to the group SCR calculation to provide a more holistic view of the group's risk profile, and to reduce the risk of regulatory arbitrage. The PRA considers this temporary flexibility will increase competitiveness and growth of the UK economy, as regulatory burden and costs will reduce for insurance groups looking to grow through mergers and acquisitions.

The PRA clarifies it will allow a group up to six months after an acquisition to create a plan to integrate any IMs. The PRA considers this additional flexibility recognises the differences in nature between insurers and provides sufficient time to assess the most appropriate approach to IM integration.

The PRA also confirms it will allow a group to bring in its overseas sub-group's group SCR under method 2 (deduction and aggregation method), which will allow diversification benefits between the method 2 entities within that sub-group. To ensure that this does not incentivise insurers to offshore UK risks to an overseas sub-group, the PRA will allow insurers to apply for this only where the relevant sub-group is subject to equivalent group supervision.

Third country branches

The PRA removes the requirement for third country branches to calculate and report branch SCR and branch minimum capital requirements. Consequently, the PRA removes the branch RM and the requirement to hold assets in the UK to cover the branch SCR. The PRA further clarifies that third

country branches are required to calculate and hold assets to cover (re)insurance obligations. These obligations should be calculated using the branch best estimate of liabilities (or the market value of financial instruments where applicable). The PRA confirms that a notional allocation of legal entity assets is acceptable to cover (re)insurance obligations, but that assets should only be allocated to the branch where they would be available to pay branch policyholders in a winding-up scenario.

The PRA considers that its rules to remove certain third country branch requirements are a proportionate approach to insurer safety and soundness and policyholder protection, given a branch cannot fail independently of the third country insurance undertaking. For example, the PRA explains that when assessing branch authorisation, the PRA must be satisfied that the home jurisdiction's prudential supervision regime is 'broadly equivalent'. Further, the third country branch undertaking must maintain adequate worldwide financial resources to meet the requirements for branch authorisation and ongoing supervision. Additionally, when assessing branch authorisation, the PRA must satisfy itself that, in an insolvency, branch policyholders will be given appropriate priority, and will not be disadvantaged in the event of a winding up.

The PRA confirms that its rules on third country branches in PS2/24 do not apply to Swiss general insurers. Relevant requirements are contained in the UK-Swiss Direct Insurance [Agreement](#). Further, the UK and Switzerland signed a [mutual recognition](#) agreement on 21 December 2023.

Reporting and disclosure

Following proposals in CP14/22 and CP12/23, the PRA sets out its final SUK reporting and disclosure policy in PS3/24. The PRA's rules build on earlier reporting reforms set out in [PS29/21](#).

The PRA confirms it will remove, amend and introduce new reporting requirements for insurers. The PRA considers that overall, the proposals would result in a net reduction of reporting for insurers (with 55 reporting templates to be removed). And while the PRA's proposals focus on supervisory reporting reforms, the PRA indicates it may review the SFCR going forward.

The PRA removes the requirement for insurers to submit the Regulatory Supervisory Report (RSR) for several reasons, including it being burdensome for insurers to prepare. The PRA confirms it removed the requirement to submit the RSR in December 2023. However, for third country branches the PRA introduces a short standalone resolution-focused report, given it will no longer be receiving this information through the RSR.

After considering feedback to CP14/22, the PRA clarifies it will no longer be implementing a new reporting template on non-life product obligations. It will also not introduce the reporting template on activity by country, and instead will introduce simplified versions of the existing solo level reporting on insurance activity and best-estimate liabilities as the basis for country level reporting. Additionally, the PRA clarifies it has simplified the new reporting template on cyber underwriting risk, removing granular detail on target market, product identification and risk coverage.

The PRA streamlines existing SCR reporting by insurance groups, and amends third country branch reporting given the removal of branch capital requirements and RM, which renders some existing reporting obsolete.

Given third country branches are required to maintain adequate worldwide financial resources, the PRA presently reviews the adequacy of these worldwide financial resources by collecting information on the third country branch undertaking as a whole, as part of the authorisation process and then on an ad-hoc basis. The PRA rules formalise this requirement, requiring third country branches to report information of the capital and solvency position of the branch legal entity on an annual year-end basis and on a three-year forecast basis.

Mobilisation

The PRA introduces an optional 12-month mobilisation period for new insurers, particularly start-ups. During this time the PRA will apply proportionate regulatory requirements to insurers which includes lowering the absolute floor to the minimum capital requirement to £1m.

During mobilisation, the PRA restricts the business an insurer can carry on to limit risks to policyholders. For example, insurers will be limited to effecting insurance contracts so that the insurer's total net exposure remains below an aggregate sum insured / assured of £50,000 and should not include liability insurance. And to exit mobilisation, insurers will need to apply to the PRA for a Variation of Permission, demonstrating that they can meet regulatory requirements in full going forward, including applicable capital requirements.

The PRA considers its rules would facilitate entry of prospective insurers into insurance markets by providing insurers with the certainty of being authorised as they complete the final stages of their set up. For example, this will allow insurers to secure further investment, recruit new personnel, and strengthen operational capabilities while being authorised.

Thresholds

The PRA increases the size thresholds for determining whether an insurer is regulated under the SUK regime or the

non-Directive firm (NDF) sector rules. The thresholds increase from:

- €5m to £25m for an insurer's GWP (an increase of £10m from the original proposal of £15m in CP12/23); and
- €25m to £50m for insurer and group technical provisions.

With respect to reinsurance, the threshold for the amount of reinsurance operations in relation to:

- GWP will increase from £530,000 to £2.5m; and
- gross technical provisions will increase from £2.4m to £5m.

Insurers will benefit from the Solvency II exemption to the extent they do not exceed the thresholds for three consecutive years and do not expect to exceed the thresholds in the following five years. Further, insurers that do not exceed the new increased thresholds will continue to be able to operate within the SUK regime should they wish to, by applying for a voluntary requirement.

The PRA considers these changes will result in a more proportionate approach to the regulation of smaller firms, as NDFs generally benefit from simpler requirements, including simpler capital standards, reporting forms, and governance requirements.

Currency redenomination

Following the UK's withdrawal from the EU, the PRA redenominates monetary values in its Solvency II PRA rules from EUR to GBP. The PRA considers this will lead to more consistency for insurers.

What do firms need to do?

Insurers will need to ensure they have plans in place to implement the changes finalised by PS2/24 and PS3/24. This includes any changes to policies and systems by 31 December 2024. For those insurers that wish to continue to use the legacy approach to TMTP, they have until the end of June 2024 to submit their application to the PRA.

With the reduction in the RM, reinsurance and capital management strategies will need to be reviewed along with hedging levels. Life insurers may wish to model the changes to the RM, TMTP and the proposed changes to MA as these are likely to impact their reinsurance, capital management and investment strategies going forward.

International insurers looking to set up operations in the UK might wish to consider how the removal of branch capital requirements could impact their optimal capital structures. Insurers with operations in the UK and the EU will need to consider whether divergences in prudential rules will require changes to systems and the set up of control functions.

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Next steps

Insurers must implement the changes confirmed in PS2/24 and PS3/24 by 31 December 2024. While these policy statements do not cover changes to the MA which were consulted upon in CP19/23, the PRA confirms it is still planning to have final policy on the MA in place by the end of June 2024.

The PRA also intends to consult in Q2 2024 to transfer the remaining Solvency II requirements into PRA rules. These changes will need to be implemented by 31 December 2024, in line with the changes in PS2/24 and PS3/24.

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