Financial Services Regulatory Insights

PRA launches Solvency II Quantitative Impact Study

AT A GLANCE

July 2021

What's new?

- The PRA issued a Dear CEO letter announcing the launch of Review of Solvency II: Quantitative Impact Study (QIS) on 20 July 2021. The QIS is particularly relevant for life insurers as it focuses on three key structural components of a life insurer's balance sheet: the risk margin, the matching adjustment (MA), and the transitional measure on technical provisions (TMTP). The QIS exercise asks firms on a voluntary basis to provide data on potential Solvency II reform options using different calibrations and designs for the risk margin and MA across a range of economic scenarios.
- The Government launched its Review of Solvency II: Call for Evidence in October 2020, asking for feedback on ten specific areas for reform of Solvency II (see our At a glance for further details). Subsequently, in July 2021, HM Treasury published Review of Solvency II: Call for Evidence - Response confirming these ten priorities and announced that PRA in agreement with HM Treasury plans to launch a QIS to move forward with the Solvency II review.(see our At a glance for further details).
- The PRA plans to use the QIS data to model potential policy options to assess which combination of reforms to Solvency II would best meet the Government's objectives to enable insurers to provide long-term capital to support growth across the UK and the Government's climate change objectives. The PRA will also use the QIS data to assess what the aggregate impact would be on the insurance sector and analyse how various policy options are likely to perform through the economic cycle.

What does this mean?

- The QIS asks firms to calculate their balance sheets and solvency capital ratios under different scenarios as explained below. Within each scenario firms are required to assume different sensitivities in respect of risk free interest rates (e.g. SONIA +200/-100bps), bond yields (e.g. +200/-100bps) and credit spreads and downgrades. The QIS scenarios also include design and calibration specifications for various components of the fundamental spread (FS) such as credit risk premium and valuation uncertainties. Firms with approval to use TMTP are required to recalculate the TMTP after allowing for the impact of the sensitivities and specification under each scenario. Detailed information regarding the various scenarios and instructions for completing the QIS can be accessed here. The valuation date of the QIS and all scenarios is year-end 2020.
- Scenario A: For the balance sheets calculated in Scenario A, along with using various FS and interest rate/credit sensitivities and specifications, the QIS requires the risk margin to be calculated using the margin over current estimate (MOCE) approach.The MOCE for life and non-life insurers is based on 85th percentile and 65th percentile respectively of their SCR for non-hedgeable risks. This risk margin method is currently used under the International Capital Standard developed by the IAIS.

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- Scenario B: For the balance sheets calculated in Scenario B, along with using various FS and interest rate/credit sensitivities and specifications, the QIS requires the risk margin to be calculated using a 'risk tapering' (also known as the 'lambda') approach. This approach is equivalent to that set out in EIOPA's Opinion on the 2020 Review of Solvency II. The lambda approach reduces the sensitivity of the risk margin to interest rate changes.
- Data validation and approval: The PRA expects firms to ensure that the QIS data is consistent with the YE 2020 QRTs and to undertake reasonableness checks on the direction and magnitude of the balance sheet movements. In addition, the PRA requires firms to validate the data and obtain sign-off of the QIS submission from an appropriate individual approved under the SM&CR.

What do firms need to do?

- Firms only have three months to respond to the data requests and the PRA wants firms to prioritise resources to complete the exercise. Given the technical nature, tight timescales and scope of the QIS, firms will need to consider resourcing and capacity of their actuarial and finance teams to complete the QIS while balancing BAU activities and other change programs such as IFRS 17 implementation. Although participation in the QIS is voluntary, insurers may wish to consider which areas of the review are most relevant for their business and decide if they wish to participate in the QIS.
- Life insurers may wish to model the various scenarios outlined in the QIS in relation to the changes to the risk margin, TMTP and the MA as these are likely to impact their reinsurance, capital management and investment strategies going forward. Although the QIS does not cover changes to the Standard Formula (SF), firms using the SF may still be impacted by other changes (e.g. risk margin) and may wish to model the impact of relevant QIS proposals to assess the impact on their capital requirements.
- Given that the PRA expects firms to internally validate their QIS results and requires a Senior Management Function holder to sign-off the firm's QIS submission, firms will need to establish appropriate validation and governance procedures around their QIS submissions.

Next steps

In August 2021, the PRA plans to release a series of qualitative questions on topics such as the eligibility criteria for assets in the MA portfolio, regulatory processes around internal model and MA approvals, and the cost of implementing reforms. The qualitative questions will also explore how potential changes to the balance sheet may affect a firm's risk appetite, business plans, reinsurance, and investments.

The deadline for submitting responses to the QIS is 20 October 2021. Subsequently, the PRA plans to launch a comprehensive package of reforms for consultation in early 2022. Therefore, it is unlikely that any changes to Solvency II would come into effect before FY 2023-24.

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