Financial Services Regulatory Insights

UK Government overhauls Solvency II

AT A GLANCE

November 2022

What's new?

- HMT published Review of Solvency II: Consultation – Response on 17 November 2022 setting out the Government's final reform package and the plans for implementing changes to the UK's prudential regime for insurers. The Government states that it will legislate as necessary to implement the new Solvency regime which is part of the Government's wider reform programme to tailor financial services regulation to UK markets.
- The changes to Solvency II relate to: risk margin (RM); matching adjustment (MA); increasing investment flexibility; and reducing reporting and administrative burdens. The Government expects that the package of reforms will enable insurers to increase investment in long-term productive assets and ensure that the UK maintains an internationally competitive insurance sector without compromising policyholder protection.

What does this mean?

- The changes can broadly be grouped into the following areas:
  - **Reduction in RM:** The Government states that it will legislate as necessary to achieve a reduction in the RM for long-term life insurance business, including Periodic Payment Orders, by 65%, and for general insurance business by c.30%. The Government states that a modified cost of capital method should be used to calculate the RM.
  - **Broader scope of MA eligibility:** The Government confirms that it will introduce changes to broaden MA eligibility to include assets with prepayment risk or construction phases and remove the severe treatment of assets whose ratings fall below BBB. In addition, the Government will also replace the requirement that all MA eligible assets have fixed cash flows with a more flexible requirement that such assets have highly predictable cash flows, thereby reducing the cost of asset restructuring and securitisation. Furthermore, the Government plans to broaden the liabilities eligible for the MA to include income protection products and products that insure against morbidity risk.
  - **Unchanged fundamental spread (FS) calibration with increased supervisory oversight -** The Government has decided to leave the design and calibration of the FS unchanged. The new rules will however, increase the risk sensitivity of the current FS approach by allowing different notched allowances to be made within major credit ratings (e.g. different allowances for assets rated AA+ or AA- compared with AA). Additional new measures to mitigate any potential prudential risks will require insurers to participate in regular stress testing exercises prescribed by the PRA and for firms to nominate senior managers (SMF holders) to attest to the PRA whether

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or not the level of the FS is sufficient with the potential of FS add-ons being used where the FS is not deemed sufficient. Moreover, the PRA will have powers to seek assurance on internal ratings and require firms to make changes and adjustments where appropriate. The Government plans to review the calibration of the FS in five years' time.

- **Streamlined regulatory approvals:** The Government states that it will work with the PRA to update approval requirements for firms' internal models to streamline the number of requirements while allowing the PRA to exercise more supervisory judgement in assessing the adequacy of firms' models. The Government will also set up a mechanism for the PRA to provide regular reports on MA approval rates and timelines.
- **Increase in threshold for Solvency II**: The Government says it will increase the thresholds for the size and complexity of insurers before Solvency UK applies to £15 million in annual gross written premiums (triple the previous threshold) and to £50 million in gross technical provisions (double the previous threshold).
- **Removal of capital requirements for branches**: The Government says it will remove capital requirements for branches of foreign insurers based in the UK and will legislate as necessary to enable the PRA to do so.
- **Mobilisation regime for new insurers**: The Government confirms the introduction of a new mobilisation scheme for insurers. Such a regime would create an optional stage in a prospective insurer's entry to the market, including adjusted entry requirements such as a lower capital and governance requirements.

What do firms need to do?

- Firms will need to review their asset strategies in the light of greater eligibility and investment freedom and whether to expand the scope of their MA or submit new applications to cover other liability classes. They will also need to consider the new risks introduced and how these will be mitigated. Those responsible for attesting the adequacy of the FS will need to set up robust validation and governance arrangements around the approval processes to demonstrate this.
- Internal ratings, already a focus of the PRA, are likely to come under even more scrutiny and assurance may be required. Logistically firms will need to reflect notching in the FS and be able to perform the PRA's prescribed stress tests. With the reduction in the RM, reinsurance and capital management strategies will need to be reviewed along with hedging levels.
- 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.

Next steps

Government plans to legislate as necessary and work with the PRA to make changes to its rulebook to implement the new rules. The PRA and FCA will jointly review and assess whether changes may be needed to the Financial Services Compensation Scheme or levy for insurers, in light of the Government's reforms.

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