GOVERNMENT TO REFORM REGULATION OF THE UK INSURANCE SECTOR

On Monday 19 October, HM Treasury issued two papers on regulatory reform after Brexit. The first paper, a Call for Evidence, seeks industry views on how to tailor the prudential regulatory regime under Solvency II to better support the unique features of the UK insurance sector. The second paper, a consultation, launches the next phase of the Future Regulatory Framework (FRF) Review, which considers how the UK's regulatory framework for financial services could be adapted for the UK's post-Brexit future.

CALL FOR EVIDENCE

In June 2020, the government announced its intention to review some aspects of Solvency II. The Call for Evidence is the first stage of that review, with the Treasury now inviting stakeholder views on areas of Solvency II that could be enhanced. The government states the review is underpinned by three objectives:

- to spur a vibrant, innovative and internationally competitive insurance sector;
- to protect policyholders and ensure the safety and soundness of firms; and,
- to support insurance firms to provide long-term capital to underpin growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets, as well as investment consistent with the government's climate change objectives.

Solvency II, as implemented in 2016, followed a maximum harmonisation approach designed to cover the entire EU insurance market. As such, it would be problematic to adjust Solvency II at an EU level to reflect certain specific features of the UK market. Once the transition period ends, the UK will no longer be constrained by the EU legislative framework and, in issuing the Call for Evidence, the government is confident that it will have the legal remit to alter some aspects of Solvency II to encourage growth in the UK and new market entrants.

The Call for Evidence signals the UK's departure from EU rules without waiting for an EU confirmation of Solvency II equivalence. Presumably, by the time the Treasury gets feedback from the EU on the UK's equivalence position, this will influence the eventual approach to the UK's revisions of Solvency II.

Although the Treasury deems the prescriptive model inherited under Solvency II not fit for the UK, it is not clear how and to what extent any reforms will be taken forward, although a significant rewrite of onshored legislative material is expected. The government will decide how to implement reforms later next year, most likely once the revised UK regulatory framework as a result of the FRF Review is in place.

Areas under review

Risk Margin: Given the PRA's representations to the Treasury Select Committee on Solvency II back in 2018, it is no surprise that the first item mentioned is the risk margin, the additional capital buffer insurers hold for non-hedgeable risks. As the Call of Evidence notes, UK life insurers who underwrite significant quantities of long-term life business with guarantees, such as annuities, are disproportionately impacted by the Solvency II methodology used to calculate the risk margin. Also, the risk margin has been criticised for being too volatile, especially when interest rates are so low. Life insurers' attempts to reduce their risk margin by reinsuring longevity risk to overseas counterparties has also made supervision more complex for the PRA.

The Call for Evidence does not set out a solution for the risk margin, but asks for views on "the preferred means of modifying the current 'cost of capital' approach". Impacted insurers should, therefore, forward proposals especially if another methodology is preferred.

Matching adjustment (MA): Under current rules, the MA is restrictive in the types of liabilities and assets that qualify, with the Treasury now exploring the possibility of loosening eligibility requirements. The costs and complexities of restructuring assets so that they qualify for the MA also acts as a barrier to its use by smaller firms.

The Treasury wants to simplify the approval of the MA portfolio, including permitting the PRA to give approvals beyond currently ‘binary yes/no’ final decisions, with more engagement from the PRA to guide insurers through the application process. As the MA is often used with long-term assets which are exposed to climate risks, the Treasury wants to understand how the MA could better reflect these risks and contribute to sustainable investment.

Solvency capital requirement (SCR): The Treasury is looking at improving the standard formula, which could mean greater use of adjustments and insurers avoiding the more complex internal model route. For an internal model, easier requirements and approval processes with more flexibility in the internal model design are being considered. The Treasury is also looking to give the PRA more flexibility in how it applies both methods.

The Treasury argues that flexibility to assess the adequacy of a firm's financial soundness as a whole should lead to more efficient use of resources by regulators and insurers. One such case involves climate risk. As climate risks manifest over many years, these may not be captured in the one-year time horizon on which the SCR is based. The Treasury wants to know how the SCR can support its government's climate change objectives.

Group capital calculations: Capital calculation issues, such as double-count risks, can result from mergers and acquisitions (M&A) of insurance groups with internal models. To resolve these difficulties, the Call for Evidence asks what factors should be considered if the PRA were to be given powers to allow for temporary calculation of consolidated group SCR using multiple internal models following M&A.

Transitional measure on technical provisions (TMTP): The TMTP is a transitional measure that allows insurers to gradually increase their technical provisions to a Solvency II basis, from when Solvency II was introduced in 2016 until 2032. Insurers applying the TMTP have to maintain pre-2016 models to calculate their Solvency I requirements, so the Treasury ask if the TMTP calculation could be simplified.

Reporting requirements: Solvency II has increased data demands on insurers, which may be particularly burdensome on smaller firms. The Treasury is seeking views on the benefits versus the costs of the current reporting requirements, including whether existing reporting waivers could be extended.

Branch capital requirements: Perhaps to allow the UK to remain a "hub" for insurance after Brexit, the Treasury seeks views on whether to reduce the regulatory burden for branches of foreign firms operating in the UK, including the possibility of removing capital requirements.

Thresholds: Below certain limits of gross written premium or technical provisions, insurers fall out of Solvency II. The Treasury asks whether the threshold could be raised, so reducing the burden on smaller firms.

Mobilisation of new insurers: New insurers are expected to exceed Solvency II minimum thresholds within five years and have to apply Solvency II from the start. The Treasury and the PRA, given its New Insurer Start-up Unit (NISU), are keen to improve the mobilisation of new insurers and seek views on a proportionate regime which reduces barriers for new entrants.

Libor transition: Insurers use discount curves based on the London inter-bank offered rate (Libor) to value their liabilities, but the publication of Libor is due to cease by the end of 2020 and be replaced by overnight indexed swap (OIS) rates. At present, the European Insurance and Occupational Pensions Authority (EIOPA) publishes prescribed discount curves, though the PRA is set to take over from 31 December this year, and it is currently consulting on whether to use the same methodology as EIOPA. The switchover to OIS-based curves presents several issues which the Treasury seeks views on including when the transition should be made.

Other areas: The Call for Evidence ends with an open question, querying other areas of Solvency II that should be considered for review. If insurers are to be encouraged to provide long-term capital to support the government's growth initiatives, including investment in infrastructure, venture capital and growth equity, then insurers may decide to respond to the open question by proposing revisions to capital charges for specific investments.

Unlike the review of Solvency II issued by the Commission in July 2020, which mentioned a lack of availability for national authorities of the right tools to deal with insurer failures, the Treasury has not any suggested lack of such tools in the Call for Evidence. However, following the adoption of the Bank Recovery and Resolution Directive (BRRD), recovery and resolution planning is now well developed for banks. We would expect the Treasury and UK regulators to soon publicly consider how insurers will be subject to similar requirements.

Next steps

Once the Treasury has reviewed the feedback, it is expected to consult in the first half of 2021 on changes which require amendments to onshored legislation, primarily the Solvency 2 and Insurance (Amendment, etc.) (EU Exit) Regulations 2019. Changes are also to be expected to be made to PRA rules, as these transpose the Solvency II Directive requirements. A significant overhaul of onshored Solvency II legislation is expected and will be made in light of the reforms to the broader UK financial services legislation initiated by the FRF Review.

FRF REVIEW

The consultation published last week marks Phase II of the FRF Review and follows Phase I which started in July 2019. As before, the Treasury reinforces its key aim: an agile and coherent approach to UK financial services regulation post-Brexit, with appropriate democratic policy input to support a stable, innovative and world-leading financial services sector. Whilst discussing the impracticalities of onshored legislation, the Treasury set a new blueprint for regulation, including new activity-specific regulatory principles for the UK regulators.

Onshoring

The Treasury makes clear that whilst the onshoring approach is right for the immediate period after the EU exit, it was not designed to provide the optimal, long-term approach for UK regulation of financial services. The Treasury points out significant disadvantages to retaining the onshored regime over the long term, including a fragmented rulebook resulting in a patchwork of domestic and retained EU legislation. Essentially, the Treasury flags a major consolidation exercise of UK legislation, including a rewrite of significant portions of the PRA Rulebook and FCA Handbook.

Blueprint

The Treasury's proposed blueprint involves adapting the Financial Services and Markets Act 2000 (FSMA) to address the significant challenges (on both the industry and the regulators) of managing the onshored regime and creating a more coherent and accountable framework for the development and application of future UK financial services regulation.

The key policy challenge is adapting the FSMA model to make the most of regulator expertise and flexibility in setting regulatory standards, while at the same time ensuring regulators take full account of broader public policy issues and priorities when designing those standards. The approach in the consultation envisages a high level of policy responsibility for the UK regulators. It also envisages a way for the government and Parliament to set out what the broader public policy issues and priorities are.

The Treasury illustrates the post-EU framework approach covering five key elements: an obligation for the regulator to maintain a specific regulatory regime; the purpose of this regime; the scope of the regime; any core elements to the regulatory approach that the government and Parliament wish to set for the regime; and regulatory principles highlighting specific policy considerations to which the regulators must have regard.

Whilst acknowledging the ongoing debate in Parliament and among industry stakeholders in recent years on whether the PRA and FCA objectives should be added to or adapted to reflect competition, the Treasury does not propose the introduction a statutory objective to support the competitiveness of the UK financial sector. The industry could consider this unhelpful as, post-Brexit, the importance of a thriving financial services sector for UK economic growth and prosperity will be paramount and because the sector will need to compete internationally.

Instead of new competition objectives, the Treasury explains that when the regulators consult on policy and rule proposals, they should be required to explain how their proposals meet the statutory purpose set for a particular regulatory regime and take into consideration the activity-specific regulatory principles. This is not something new - the regulators already have to have regard to regulatory principles in FMSA but these are drafted broadly.

Next steps

The deadline for responses to the consultation is 19 January 2021. The Treasury intends to use the responses to inform a second consultation, to be published in the first half of 2021, and which will set out more detail on the new approach.

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