INSURANCE, ASSET MANAGEMENT AND FUNDS

Investments by Insurers under Solvency II and Solvency UK

Solvency II came into force in January 2016, representing a significant change to insurance regulation in the EU. Under Solvency II, insurers had to treat investments differently and adopt additional reporting requirements. Following the UK's departure from the EU on 31 December 2020, the UK plans to reform Solvency II with the regime to be known as 'Solvency UK'. The EU is also amending Solvency II, with both the UK and EU introducing changes to encourage investment by insurers in 'green' assets and infrastructure. Although the UK and EU are expected to implement reforms soon, the core Solvency II requirements are expected to remain similar. This briefing outlines the key current Solvency II requirements relevant to insurers as investors and outlines where any divergence is planned.

Solvency II and Solvency UK Reform

The Solvency II regime no longer directly applies in the UK post Brexit, but the regime is largely unchanged at present as the rules have been transposed and onshored in the UK. The UK government has undertaken a review of Solvency II with the objective of freeing up capital in the insurance sector, enabling insurers to invest in projects that will benefit the wider economy. The review is being carried out by HM Treasury, in conjunction with the PRA, and aims for Solvency UK to fully reflect the unique features of the UK insurance sector rather than the wider EU insurance sector (its particular structures, products and business models) and regulatory approach.

Instead of a comprehensive regime overhaul, the UK's review focuses on specific aspects of Solvency II that would free capital currently on insurers' balance sheets. Wholesale reform is not contemplated, and capital charges discussed in this note will continue to apply. The UK's review is focused on revisions to the Risk Margin[1] (which is to be reduced around 65% for life carriers and 30% for non-life carriers), the Matching Adjustment ("MA")[2] (with various steps to be taken to liberalise the MA eligibility criteria and fast-tracking of MA applications), the removal of the requirements for UK branches of foreign insurers to calculate branch capital requirements and an increase in the thresholds before the Solvency UK regime applies which is aimed at nurturing UK insurtech businesses. For more information on the Solvency UK proposals, please refer to our briefings: The PRA Publishes Solvency UK Consultation Paper - July 2023 and Solvency UK: Reforming the Matching Adjustment to Support Investment and Growth - November 2023.

Like the UK, the EU intends to boost the insurance sector's capacity for long-term investment, in line with the EU's political priorities as set out in the Capital Markets Union plan and the European Green Deal. Accordingly, the EU Commission carried out an extensive review of various aspects of the Solvency II framework (known as Solvency II 2020 review). Like the UK, wholesale reform is not contemplated. On 22 September 2021, the Commission adopted a legislative proposal to amend Solvency II Directive. At a high level, key areas where substantive changes are proposed for the Solvency II Directive and which impact insurers' investments include changes to the operation of the proportionality principle with a new concept of "low-risk undertakings" and new rules on macroprudential and climate change considerations including a new requirement for insurers to identify material climate risks and assess the impact of at least two long-term climate scenarios on their business.

1 An additional reserve required to be maintained by an insurer above its best estimate of liabilities (BEL) and below its solvency capital requirement (SCR).

2 The MA benefits insurers who hold long-term assets that match the cash flows of similarly long-term insurance liabilities, by allowing them to recognize upfront as capital part of as-yet-unearned future cashflows by means of illiquidity premium. The MA is a particularly material benefit for insurers writing annuity business, which are thereby incentivized to invest in a wide range of long-term, illiquid, fixed-interest assets.

The final compromise text of the Solvency II Directive was published on 24 January 2024 and is now awaiting approval by member states' representatives and the European Parliament. If approved, the European Council and the Parliament will have to formally adopt the text. The publication of the final text in the Official Journal, and consequently its entry into force, is currently expected to take place in the second half of 2024. National implementation will follow 18 months after date of entry into force.

Investments under Solvency II

Solvency II abolished the "admissible asset" concept and counterparty/ asset limits that applied under Solvency I. Insurers instead calculate their Solvency Capital Requirement ("SCR"), based on a number of risk modules including market risk, which sets the capital charge applicable for individual investments. The market risk module accounts for a large percentage of an insurer's capital charge, particularly for life insurers, and effectively assigns risk weightings to equity, property and debt-based investments. The capital charge provisions under the default "standard formula" are set out in the relevant Solvency II regulation.

However, many large insurers particularly in the UK have developed and adopted (with approval from the regulator) their own tailored "internal models" or "partial internal models" designed to take into account the risks inherent in that insurers' own portfolio of business. The capital charge of investments for insurers on "internal models" may well vary from those on the standard model. In addition, many life insurers have MA approvals for their portfolios. The MA allows insurers the combination of the use of internal models and MA compliant investment portfolios means that insurers often require bespoke investment structures and strategies.

The Solvency UK reforms aim to simplify the internal model application procedure and extend the range of MA compliant assets (including by allowing assets with highly predictable cashflows in addition to those fixed cash flows to be MA compliant, although at least 90% of assets in the portfolio must still have fixed cash flows). These simplifications are, however, unlikely to standardise UK insurers' requirements, such that bespoke investment structures and strategies will still be required.

Prudent Person Principle

Solvency II also requires insurers to invest all their assets in accordance with the prudent person principle ("PPP"). This includes the requirement on insurers to invest only in assets and instruments:

- whose risks can be properly identified, measured, monitored, managed, controlled and reported;
- that ensure the security, quality, liquidity and profitability of the portfolio as a whole;
- that are appropriate to the nature and duration of insurance and reinsurance liabilities; and
- in the best interest of policyholders and beneficiaries.

As part of reforms to the Solvency II Directive, the EU has proposed amending the PPP to require insurers to consider both the impact of sustainability risks on their investments and the long-term impact of their investment decisions on sustainability factors when forming their investment strategy.

The UK has taken a similar approach but only in relation to climate change risks, through the term of the PRA's Supervisory Statement SS1/20 Solvency II: Prudent Person Principle (May 2020) that clarifies that the PRA expects firms to pay particular attention to complex risks like climate change within their investment risk management policies and emphasises the importance of avoiding overexposure to such risks. There is therefore a risk of divergence in approach given the PRAs focus on climate change and the EU's inclusion of other sustainability approach.

Look-Through

In accordance with the PPP, insurers investing in funds are also required to adopt the "look through approach" in calculating their SCR. This means that the SCR will generally need to be calculated on the basis of the underlying assets in a fund structure and this approach will need to be applied a sufficient number of times to capture all material risk. This requires insurers investing in a fund of funds or a feeder/ master fund structure to "look through" each fund and sub-fund to calculate the SCR based on the ultimate underlying assets, as far as possible.

Where the look through approach is not possible, an insurer may be able to calculate its SCR on the basis of the investment policy of the fund, provided this is strictly adhered to. Insurers would therefore look to invest in funds where the investment policy is sufficiently clear and specific, in order to apply the look through approach and understand the underlying material risks.

Insurers also require adequate reporting on the funds to apply the look through approach. If the look through approach cannot be applied (whether because of the investment policy or inadequate reporting), then the investment may need to be treated as equity (at a 49% charge for unlisted equities), which is unlikely to be attractive to insurers. For equity listed in regulated markets in the EEA or OECD (of which the UK is a member), equity (whether or not listed) that are invested through specific funds (including shares in a European Long Term Investment Funds ("ELTIF")), or "qualifying unlisted equity portfolios" as defined by Solvency II legislation, are eligible for a lower equity capital charge of 39%.

Lower charges are available where an investment is a 'qualifying infrastructure investments' which attract a capital charge of 30% or 'qualifying infrastructure corporate investments' which attract a capital charge of 36%. Even lower capital charges apply for a 'strategic equity investments' or a 'long-term equity investments' which both attract a 22% capital charge. At this time, neither the UK nor the EU are recommending changes to capital charges.

Reporting Requirements under Solvency II

Solvency II places detailed and frequent data and reporting requirements on insurers. In turn, insurers require asset managers to provide appropriate reporting to insurers on their investments and are likely to require appropriate due diligence and information on asset managers prior to appointing them, to ensure they are able to receive the information required.

Data Quality

Data used by insurers under Solvency II is required to be accurate, complete and appropriate. Data must meet the same quality standards irrespective of whether it is sourced by the insurer internally or externally. As such, there is likely to be additional pressure on asset managers from insurer clients requiring assurance in respect of the quality and consistency of data reported. An asset manager may be asked to provide comfort to an insurer by granting access for due diligence of certain relevant internal processes and controls, which may include a site visit.

To relieve the data quality and cost burden imposed by Solvency II, asset managers may wish to consider contracting a third party that can provide the look-through transparency to fund positions. These third parties can provide a 'data file' with quantitative data that can be used to meet the relevant Solvency II reporting requirement. The type of data in the 'data file' will depend on the type of insurance client and assets managed, however, in summary may include some or all of the following:

- pooled fund look-through data;
- holdings data in segregated accounts;
- position data;
- gain / loss accounting data; and
- certain SCR calculations for assets held.

Increased Frequency

Solvency II imposes frequent and detailed reporting requirements for insurers. Insurers must complete and submit Quantitative Reporting Templates (QRTs) quarterly and annually within five to eight weeks of the end of each quarter. In addition to these standardised templates, some European regulators may require National Specific Templates (NSTs), designed to address national regulatory needs not covered by the harmonised QRTs. These NSTs can be required for solo insurers or group entities, with submissions on a quarterly or annual basis.

Under Solvency II, insurers must also submit an Own Risk and Solvency Assessment (ORSA) annually, which evaluates their risk management practices and overall solvency. If there are significant changes in their risk profile, insurers are required to update and submit the ORSA within two weeks. Given these requirements, insurers will therefore need their asset managers to produce timely and accurate asset data. This information must be collected at the end of each quarter, at year-end, and, if necessary, between quarters for updated ORSA submissions.

To simplify data exchange and reporting processes, industry associations have developed the Tripartite Template (TPT), a standardised format that helps asset managers share information with insurers. This template allows for a consistent flow of data at the fund and individual holding level, enabling insurers to apply a "look-through" approach to their investments for reporting purposes.

In addition to QRTs and ORSAs, insurers must submit a Solvency and Financial Condition Report (SFCR) annually and disclose it publicly, along with a Regular Supervisory Report (RSR) at least once every three years. These requirements demonstrate the broader scope of transparency and accountability imposed by Solvency II.

Additional Requirements

In addition to the Solvency II reporting requirements, insurers are also likely to require additional reporting which is bespoke and will require close interaction between insurer and asset manager. For example, an insurer may want to have its internal model assumptions reflected in the reporting that an asset manager provides. Timescales for reporting that most insurers will require are also, in practice, likely to be more onerous than the basic requirements under the regulations. Most large insurers may require reporting within days rather than weeks after the period end.

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