Insurance outlook 2017

January 2017

Brexit and Solvency II continue to dominate the regulatory environment for insurance firms going into 2017. On the conduct side, the FCA maintains a focus on long-term products and in particular the retirement income sector. Below we take a look at some key dates and themes for the year ahead.

Key dates

Q1 2017	FCA policy statement expected on changes to the Handbook to reflect the introduction of the PRIIPs Regulation (PS to CP16/18)
7 March 2017	SIMR: final rules relating to regulatory references come into force
9 March 2017	Deadline for firms to implement any necessary changes arising out of finalised guidance on the treatment long-standing customers
31 March 2017	New rules capping early exit pension charges in personal pension and stakeholder pension contracts come into force
Spring 2017	Expected publication of policy statement to FCA consultation on information prompts in the annuity market
May 2017	Deadline for publication of SFCRs for firms with a 31 December year end
1 September 2017	Expected application date for new rules on information prompts in the annuity market
31 October 2017	EIOPA to provide elements of its technical advice to the Commission on the review of the Solvency II standard formula (with the rest due by 28 February 2018)
Mid/late 2017	SIMR: application of the extension of selected conduct rules to “standard” NEDs
1 January 2018	PRIIPs Regulation comes into force/ FCA revised disclosure rules apply

Solvency II and Brexit

The Parliamentary Treasury Committee has been gathering evidence on the impact of the Solvency II directive and the options now available to the UK in the light of the Brexit vote. The deadline for written submission was 11 November 2016 and the committee is currently in the process of hearing oral evidence.

Key points emerging from the written responses to the committee's call for evidence are:

- in general, respondents acknowledged that Solvency II has introduced some improvements in regulation and in particular greater harmonisation across the EU
- most were reluctant to see major changes post-Brexit, often citing the cost and disruption from more changes being introduced so soon after implementation of Solvency II
- there is an appetite, in particular from long-term insurers, for some changes to be made to the Pillar 1 capital rules. The number one issue highlighted is the operation of the "risk margin" aspect of the technical provisions. The PRA is in agreement with industry that this should be revised. A number of firms would also like to see changes to make the Matching Adjustment more flexible
- many firms are keen for changes to be made to Pillar 3 reporting requirements to reduce the disclosure burden
- for some the priority is continued access to European markets, although others warned against a "passporting at any costs" approach
- a number of respondents expressed some concern at the risk that the UK would be unable to influence future changes to Solvency II but might feel compelled to adopt them to maintain equivalence

"We do not see any need for a radical overhaul of Solvency II, or indeed for it to be scrapped altogether" – *Pension Insurance Corporation*

"The risk margin is fundamentally flawed and is driving poor outcomes" – *Legal & General*

We want UK policymakers to prioritise access to the EU single insurance market rather than focus on modifications to the UK's insurance regulatory system" – *Lloyd's and the Lloyd's Market Association*

EU Insurance Regulation inquiry webpage

Other Solvency II developments

SFCR: The main wave of Solvency and Financial Condition Reports are due to be published in May, allowing the first full comparison of SCR figures across the sector – with and without transitional measures and the application of the matching and volatility adjustments. The impact of transitional measures on the SCR is expected to be significant in many cases. Although most major insurers disclosed their headline SCR ratios in early 2016 and again at the half year mark, it remains to be seen how the market will respond to these more granular disclosures.

Review of the standard formula: Solvency II came into force with preparations for reviewing the standard formula already hard wired into the regime. Recital 150 to the Delegated Regulation committed the Commission to a review of the methods, assumptions and standard parameters used in the standard formula by December 2018. To this end, it issued a request for technical advice to EIOPA in July 2016 and EIOPA is expected to deliver the advice in full by the end of February 2018 (with some advice expected by the end of 2017). EIOPA published a discussion paper on the review in December 2016 calling for stakeholder input. Although the UK plans to have left the EU by March 2019, the review of the standard formula remains relevant as any changes will form part of the inherited regulatory regime adopted by the UK on exit.

Standard formula review - some key points

Interest rate sub-module calibration and methodology – EIOPA states that the current approach underestimates the risk in a low yield environment

Risk margin – proposed review of the methods and assumptions used in the risk margin calculation and the basis for calculating the Cost-of-Capital rate

Comparison of own funds classification with the CRR including issues identified with operation of the Principal Loss Absorbency Mechanism

Possible amendment to the Tier 1 own funds requirements together with the removal of the 20% cap on Restricted Tier 1

No review of the treatment of sovereign debt

Infrastructure corporates: The Delegated Regulation was amended in April 2016 to adjust the standard formula treatment of investments in “qualifying infrastructure investments”. Further advice was given to the Commission by EIOPA in June 2016 on preferential treatment for investment in “infrastructure corporates”. These are corporates where:

- the substantial majority of revenues is derived from owning, financing, developing or operating infrastructure assets; and

- the infrastructure assets are located in the EEA or OECD and involve a closed list of lines of business including energy generation and transmission, water/ wastewater services, waste management, transport assets and social infrastructure.

Criteria for preferential treatment also include fulfilment of certain tests relating to revenue predictability.

The Commission is yet to respond to the advice and the timetable for or likelihood of the changes being adopted is therefore unclear, although the expectation is that something will emerge during 2017.

EIOPA discussion paper

EIOPA advice on infrastructure corporates

Insurance Linked Securities

HMT's proposed new insurance linked securities (ILS) regime is now in an advanced stage of development. A Treasury consultation on a statutory instrument introducing a new regulated activity of "insurance risk transformation" and a new legal regime for the use of protected cell companies (PCCs) to carry out the activity closed on 18 January. The PRA and FCA consultation on the regulatory aspects of the new regime closes on 23 February.

The aim is that the new regime will allow the UK to compete with jurisdictions such as Bermuda and Guernsey in offering risk transformation through vehicles which are fully funded by the issue of ILSs. There are still a few question marks over the design of the regime, including:

- aspects of the tax treatment of PCCs, such as the treatment of "excess investments" and penalties for breach of compliance requirements

- to what extent will regulatory and tax defaults of one part of a PCC impact on the remainder of the vehicle?

- will the proposed time-frames for PRA authorisation of a vehicle and additional cells be compatible with market requirements?

What is insurance risk transformation?

Insurance risk transformation will be a new regulated activity distinct from the activity of effecting and carrying on contracts of insurance.

Key elements are:

- it must involve an assumption of risk by a "transformer vehicle"
- the risk transferred must relate to an underlying risk taken on under a contract of insurance
- the transferring undertaking must, therefore, be an insurer

HMT has indicated that it would like the regime to go live in the first half of 2017.

HMT consultation **PRA/FCA consultation**

Treating customers fairly – "legacy" business

Treating customers fairly remains at the heart of the FCA's conduct supervision work, as reflected in its recent work on the treatment of long-standing customers in the long-term insurance sector (sometimes referred to as "legacy" business). Finalised guidance was published in December 2016, following on from the publication of the findings of a thematic review in March (TR16/2). The key messages in the guidance are:

- firms need to consider what treating customers fairly means for closed-book and other long-standing policyholders
- these customers must be kept informed about their product throughout the lifecycle and at key policy events
- firms must ensure that customers are being treated fairly regarding investment performance, expense allocation and charges
- customers should not face unreasonable barriers to exit or unfair charges. Where necessary to ensure that TCF requirements are satisfied, this may mean not enforcing the strict contractual terms of a policy.

The FCA's view is that the guidance does not represent a change in requirements. Rather, it reflects the Principles for Businesses and other rules as well as expectations previously set out in other communications – for example, in the Responsibilities of Providers and Distributors for the Fair Treatment of Customers regulatory guide.

The feedback statement reflects some limited push back from industry on aspects of the guidance. One respondent suggested that the FCA was exceeding its powers by requiring firms to disregard terms and conditions to reflect changes in market standards and/or customer expectations. The FCA denies that this is what it is doing, stating that:

> *"It is not the FCA's intention to expect firms to dis-apply or amend T&Cs to reflect the changing expectations of customers. We do, however, expect T&Cs to be applied in a way that is fair to the customer."*

There may, arguably, be a fine line between the two in some cases.

What next?

In the immediate term, firms must review their business practices in light of the guidance and make changes if necessary by 9 March 2017.

Looking further ahead, it is clear that TCF remains very much on the agenda for the FCA and that firms must continue to engage proactively with the concept. The thematic review and the

finalised guidance are reminders that a box-ticking approach to compliance with policy terms is not sufficient to ensure that customers are treated fairly.

FCA finalised guidance

FCA work on retirement income

The FCA's work in the retirement sector is ongoing, including its work on annuity sales and its Retirement Outcomes Review looking at competition in the sector.

Most recently the FCA has published a thematic review of annuity sales practices (October 2016), looking in particular at the extent to which the availability of enhanced annuities was being communicated to customers, and a consultation paper on implementing "information prompts" in the annuity market (November 2016), with further work still in the pipeline. Some of the key points arising out of this work are summarised below.

Thematic review of annuity sales - key points	• No evidence of industry-wide or systemic failure to provide customers with sufficient information resulting in actual loss to customers • High level of failure of processes • Some firms asked to review non-advised annuity sales to identify customers eligible for compensation • Review widened to include additional firms with large numbers of annuity sales
Consultation paper on information prompts - key points	• New rules aimed at helping consumers choose the best annuity provider at retirement • Firms must include information showing the difference between a provider's own quote and the highest guaranteed quote available on the open market • Addresses the 2014 thematic review finding that 80% of consumers who purchase an annuity from their existing provider could get a better deal on the open market
Retirement Outcomes Review	• Terms of reference published in June 2016 • Ongoing review of competition in the decumulation market • Includes current work on wake-up packs and what information customers use in decision making • No fixed timetable for future publications

Thematic review of annuity sales

Consultation on information prompts

Insurable interest

The final part of the Law Commissions' insurance contract law reform project resulted in the publication in April 2016 of a consultation on a draft bill reforming the law of insurable interest. To date the final bill has not been published and we understand that some consultation responses continued to express concern at the possible impact on the legal distinction between insurance and derivatives, as well as other non-insurance risk transfer instruments.

Insurable interest has proved to be the most difficult part of the project. The draft bill consultation was published after two earlier issues papers on the topic (in 2008 and 2015), as well as discussion as part of the Commissions' 2011 consultation paper on post-contract duties and other issues. Assuming the Commissions press on with proposed reforms we can expect to see a final bill or potentially a further consultation some time in 2017.

Law Commission webpage

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